C.D. Howe Institute

EXECUTIVE SUMMARY

Taking the Initiative:
Canada's Trade Options in a Turbulent World

Richard G. Lipsey
and
Murray G. Smith

The Challenges

North America's economic prospects are being challenged by powerful economic and technological forces reshaping the world trading environment. New competitive pressures are provoking protectionist responses to which Canada is particularly vulnerable. Access to international markets is a major factor in Canada's development prospects because of its importance in encouraging the innovation and investment activities that are key to new employment opportunities and continued growth in individual living standards.

Yet Canada is one of the very few industrial nations lacking guaranteed access to a market of 100 million people. If Canada is to improve its future economic prospects, major initiatives in Canadian trade policy are required now.

Taking the Initiative examines Canada's trade options in four parts. Part I focuses on the forces reshaping the world economy and their implications for Canada. Chapter 1 outlines three global forces that are at work: rising competitive pressures, increasing protectionism, and the enormous U.S. trade deficit. Chapter 2 examines the implications of these forces for Canada's economic prospects. If Canadian industry is to be internationally competitive in the world of the year 2000, it will have to move "up market" by engaging in the production of more specialized goods and services than is the case in the mid-1980s. Chapter 3 illustrates why trade liberalization is the preferred policy response to ensure such economic gain.

Part II evaluates the trade policy options that Canadians have debated, and concludes that negotiation of a bilateral trade agreement with the United States offers the best prospect of securing the export access that the Canadian economy requires. Part III examines Canadians' political, cultural,

and economic concerns about such an arrangement. The complex and difficult issues that could be involved in negotiating and implementing this agreement are also addressed. Part IV concludes that Canada should negotiate such an arrangement with the United States as soon as possible.

The Options

Canada has a limited number of trade policy options for adapting to the global economic pressures of the late 1980s. It could attempt to maintain the status quo; it could adopt inward-looking protectionist policies; or it could take a more outward-looking orientation. Although they are not mutually exclusive, the latter alternatives could stress any one of several different approaches, such as aggressive export promotion, multilateral negotiations, or bilateral negotiations with the United States. Chapter 4 examines and evaluates these options.

The Danger of the Status Quo

The forces shaping global trade patterns make the status quo an increasingly risky policy alternative for Canada for two reasons. First, the implications of a more aggressive approach to trade policy by the U.S. Congress are serious. Canada runs major risks in this regard. The United States may no longer implicitly exempt Canada from voluntary export restraints that it negotiates with other exporting countries. Also, the future application of U.S. fair trade laws may restrict Canadian exports and such domestic policies as subsidization of particular regions, sectors, and economic activities.

Second, although important, the greater market access that Canada obtained in the Tokyo Round of multilateral trade negotiations is not sufficient either to guarantee Canada secure access to foreign markets or to provide the incentive for the rationalization of most Canadian industries to secure world-competitive costs. Potential improvements in market access that Canada might gain in the next round of multilateral negotiations are an uncertain and remote prospect on which to base today's investment decisions.

The Inward-Looking Option Rejected

The inward-looking option involves industrial policies of protection and subsidies to encourage production for the domestic market at lower cost. Because this policy prescription is unlikely to result in Canadian industries becoming more efficient and cost competitive, and because it overlooks the danger of foreign retaliation against protectionist measures, it risks eroding Canada's economic prospects and sapping its cultural vitality.

The Outward-Looking Options

Chapter 4 examines three main types of outward-looking trade policies:

- Variations on the "Third Option" proposed in the early 1970s, which would have Canada adopt an interventionist strategy based on export promotion, particularly to developing countries. This option does not offer Canada sufficient new access to foreign markets and it could prove costly if Canada chooses to compete in the high-stakes game of export subsidies.
- The aggressive pursuit of multilateral trade negotiations, through which it might be possible to reach agreement among small groups of industrial countries on the control of some types of nontariff barriers (NTBs). But the protectionist bias in the European Community and tensions between the United States and Japan make significant progress seem unlikely for several years, and perhaps much longer.
- The pursuit of bilateral initiatives to liberalize trade with the United States (in conjunction with multilateral negotiations). This is the only option that seems to offer a realistic prospect for a major improvement in Canadian export opportunities.

Negotiating Freer Bilateral Trade

Chapter 5 examines three alternative routes by which freer bilateral trade between Canada and the United States could be pursued:

- Sectoral free trade negotiations could be revived. The evidence suggests, however, that it would be very difficult to identify individual sectors in which both countries would have a mutual interest in freer trade. As a result, much negotiating effort could be spent on obtaining disappointingly small results.
- Tariffs could be left as they are and negotiations could focus on the removal of NTBs. Although Canadians might find this option attractive, its potential for gains seems limited for several reasons. First, despite the low average level of tariffs on trade between the two countries, the complex structure of existing tariffs significantly distorts bilateral trade and investment and imposes costs on both countries. Second, on NTBs, the U.S. Congress appears unwilling to remove existing procurement preferences or to alter the U.S. system of contingent protection on a piecemeal basis. Thus, at best, this approach appears to have very limited chances of major success. Furthermore, time and effort spent on such piecemeal negotiations could divert attention from more potentially effective approaches.
- Canada and the United States could negotiate a Canadian-American Free Trade Area (CAFTA), which, by a process of elimination, would

seem to be the only effective means of initiating the bilateral option. The major advantage of this over the piecemeal approaches is that CAFTA negotiations would start out with the assumption of providing a comprehensive coverage both of trade flows and trade barriers, and would permit exclusions only for very special cases.

Of the three approaches, only the negotiation of what is called a "free trade area" under Article XXIV of the General Agreement on Tariffs and Trade (GATT) would appear to offer the prospect of achieving for Canada secure access to a large market. A CAFTA would involve eliminating "substantially all" bilateral tariffs and quantitative restrictions on trade in goods and services. In addition, it would involve control of NTBs, including the contingent protection systems of both countries and the nondiscriminatory application of public procurement and other policies.

Canadian Concerns

The proposal of a free trade area raises difficult questions for both countries, but Canada, as the smaller partner, faces particularly serious concerns. Many Canadians who see the economic advantages of a program for major trade liberalization with the United States are held back by deep-seated concerns that Canadian political and cultural independence will be compromised. Chapter 6 scrutinizes these fears and concludes that such a loss can be avoided under a CAFTA. Indeed, in some ways, Canada's freedom for independent policy maneuver could be enhanced by the security offered by a CAFTA. As is spelled out in that chapter, however, cultural services in Canada may require special treatment in negotiations. In some cases, alternatives to Canada's present cultural support policies could be found that would be consistent with the general principles of a CAFTA. In other cases, such as certain support policies for the media, exemptions from CAFTA principles might have to be negotiated at the outset.

There are also deep concerns, examined in Chapter 7, that a CAFTA would cause major economic disruptions. Adjustments would be required in both countries, but they would be a continuation, and slight acceleration, of those the economy has been making successfully to GATT-inspired trade liberalization over the last two decades. Much of the Canadian adjustment to bilateral trade liberalization will certainly occur through product specialization and industry rationalization, which would not require large-scale movement of labor and capital from one industry to another. As with any of the other forces already impinging on the Canadian economy, a CAFTA is likely to eliminate some jobs in specific industries. However, it

is also likely to increase overall employment opportunities as Canadian industries become more competitive in world markets in the longer term.

Chapter 7 addresses particular concerns about the consequences of a CAFTA for Canadian manufacturing. It observes that while some multinational companies may divest themselves of their Canadian operations, Canada's manufacturing industries would survive; important components of the sector can be expected to thrive. Strong incentives exist for Canadian manufacturers to respond to freer trade by rationalizing production for the North American market, as has occurred in previous moves toward freer trade. Furthermore, elimination of U.S. tariffs and the control of NTBs would remove strong pressures that may now exist for Canadian firms to invest in the United States.

Chapter 7 also examines concerns that free trade would force Canada to harmonize its tax and subsidy policies, as well as its social legislation, with those of the United States. In some cases, this concern is misplaced. Medical and hospital care, for example, imposes real costs on the society, but the choice between public and private funding of such costs should not confer on one country competitive advantages over the other.

Considerable limitations already exist on Canada's room to maneuver in setting domestic policies. Current U.S. countervail law is a formidable threat to Canadian subsidy policies. The potential for migration of people and investment already constrains existing Canadian tax policies. Indeed, by increasing the rewards from economic activity in Canada and providing treaty-protected access to the U.S. market, a CAFTA would potentially enhance Canadian policy independence.

What the Debate Should Now Be About

Negotiating a CAFTA would break new ground in international economic relations. But it would also require compromises by both countries. Chapter 8 analyzes major negotiating issues. Each country would bring its own interests to the negotiations. The United States would seek freer access to its largest export market through the reduction of the relatively higher Canadian tariffs. Other U.S. objectives would be to expand exports of high-technology goods and services and to provide greater security for U.S. direct investment in Canada. Canada would seek the removal of U.S. tariff and nontariff barriers, such as government procurement preferences, that impede the further processing of resource products in Canada and discourage investment in world-competitive manufacturing industries.

Negotiations about the bilateral application of contingent protection mechanisms will present difficulties. Although both countries are likely to wish to retain key elements of their "fair trade" laws — notably antidump-

ing and countervailing duties — that are directed against "unfair" trade, anomalies in present laws can potentially distort bilateral trade. Thus, both countries might wish to limit the "unfair" use of such laws. At the same time, there could be bilateral exemptions in the application of import relief measures, since competitive conditions in the two economies are so closely attuned.

Chapter 9 discusses important issues that would also arise in implementing a bilateral trade agreement. One set of issues pertains to adjustment to freer trade. Since the Canadian market is smaller and tariffs higher than those of the United States, Canadian producers likely would face greater adjustment costs in coping with import competition as Canadian trade barriers are dismantled. One solution to this problem could be to eliminate trade barriers faster in the United States than in Canada. At the same time, adjustment assistance could be provided to older workers employed in industries that are particularly vulnerable to import competition.

Some Canadians express serious concerns about the future continuity and viability of bilateral free trade. Chapter 9 concludes by examining the legal and institutional mechanisms to help secure improvements in market access that would result from a CAFTA. The best protection, however, is likely to be that a wide range of domestic interests in both countries have a stake in maintaining the arrangement.

It's Canada's Move

Chapter 10 observes that there are two reasons Canada needs to decide soon to initiate negotiations for a CAFTA. First, under the U.S. *Trade and Tariff Act of 1984*, the U.S. administration must seek congressional approval to begin negotiations for a free trade area in response to a foreign initiative. Obtaining such approval could become more difficult as the 1986 elections draw near, since Congress is likely to become even more sensitive to protectionist pressures. Second, it is important that substantial progress be made in negotiating a CAFTA before both countries become preoccupied with the next round of multilateral trade negotiations. Indeed, serious negotiations for a CAFTA could be a catalyst to the multilateral process and could help pioneer approaches that would be useful in the GATT negotiations.

The decision that Canada makes now on trade policy will have permanent consequences for the North American economy. Canada's economic growth prospects are at stake, but the repercussions are much broader. Because the issues involved are complex and the decision irreversible, a thorough debate is essential. The choice for Canada and the United States is whether the two countries wish to demonstrate to the rest of the world that freer trade is the practical key to future prosperity.

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Richard G. Lipsey

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Murray G. Smith

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Canada's Trade Options

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Foreword

Turbulence and frictions in world trade are reaching a frequency and magnitude not experienced before in the postwar period. Patterns of comparative advantage are being reshaped by newly industrializing countries and by technological changes in advanced countries. Capital flows dominate exchange-rate movements and, therefore, exert a significant influence on trade flows. Situated beside and closely integrated into the economy of the United States, which is increasingly subject to protectionist pressures, Canada is being forced to reevaluate its trade policy.

The C.D. Howe Institute, in its own evaluation of Canada's future trade policy options, has concluded that one option that should be rejected by Canadians is a passive, reactive stance. The stakes, in terms of orienting the economy to the fast-moving competitive world of the next century, of ensuring continuing growth in individual living standards, and of preserving Canada's cultural and political independence, are too high.

The Institute is publishing this study of Canada's trade policy options in order to assist an informed debate among Canadians. The study examines Canada's economic predicament and the main trade policy options among which Canadians must choose. Traditionally, the policy analyst assesses the options and the tradeoffs in choosing among them. In this study, however, we believe one of the most important analytical contributions to be made is to examine the issues in negotiations of options for trade liberalization. We, therefore, choose among the options, and conclude that Canada's long-term economic interests are best served by pursuing bilateral liberalization of trade with the United States. This choice is not intended to preclude the pursuit of a new round of multilateral trade negotiations. The third part of the study examines the issues in pursuing bilateral liberalization, including those of negotiation and implementation.

The study is co-authored by Dr. Richard Lipsey FRSC, the Institute's Senior Economic Advisor, and Murray Smith, Senior Policy Analyst and Canadian Research Director for the Canadian-American Committee. Bruce Ewen provided invaluable research assistance. They were ably assisted in manuscript preparation by Debbie Watson and Lauretta Forsythe; Barry Norris edited the manuscript.

As with all of the Institute's independent policy research projects, the views expressed are those of the staff. They do not necessarily reflect those of the Board of Directors or members. The authors benefited greatly, however, from discussions and consultations with the C.D. Howe Institute Policy Analysis Committee, the Canadian-American Committee, and many others in the public and private sectors in Canada and the United States.

Wendy Dobson
Executive Director
April 1985

Preface

This study had its beginnings when I was asked in the summer of 1983 to write the chapter on Canadian-U.S. economic relations in a forthcoming book on Canada and the United States sponsored by the American Assembly. In the course of the next year, I delved into the post-Confederation history of Canadian economic policy with respect to trade and foreign investment. Slowly, I was forced to two conclusions. First, major changes are needed in Canada's trade policy if our country is to have a satisfactory future. Second, the only chance for the major changes that are needed in our trading relations lies in bilateral trade liberalization with the United States — pursued in conjunction with, not as an alternative to, multilateral negotiations for trade liberalization.

At the time that I contemplated the present study, I felt that, although I would be a voice crying in the wilderness, I had a duty as a Canadian to do what I could to sound the alarm that status-quo policies would subject our country to serious, and unacceptable, economic risks. Wendy Dobson, Executive Director of the C.D. Howe Institute, agreed with me. Murray Smith, Senior Policy Analyst at the Institute, became my collaborator on the present monograph. Events then overtook us. Instead of being two lone, and futile, voices crying in the wilderness, we soon found ourselves members of a large chorus calling for a significant liberalization of our trading relations with the United States.

As Canadian patriots, we worried about all of the familiar cultural, social, and political issues that arise in the minds of Canadians when they contemplate closer trading relationships with the United States. While understanding that the United States is the bulwark of the western defense system, we have been critical, along with many Americans, of some past and current U.S. foreign policies. Thus, we were concerned about Canada's independence to be a friendly critic of U.S. policy. With these concerns in mind, we set out to consider Canadian worries. To our surprise, when we looked at these issues as dispassionately as we could, we were forced to the conclusion that our cultural and political sovereignty would be increased, rather than diminished, by achieving treaty-protected access to the U.S. market.

As late as December 1984, we still envisioned that our contribution would be a brief one. But the more we learned about the subject, and the more we consulted with others, the more we realized that much more length would be required to give anything other than a superficial treatment of the many complex issues that are involved.

Even now the issues are sufficiently complex that any one of the chapters could be expanded into a full monograph, still without doing total justice to all of the issues.

Since not everyone will be equally interested in all of the issues, and some will already be persuaded on some of them, we present here a guide to the monograph that may help readers to pick their way through the material.

Chapter 1 deals with current developments in the world economy that are particularly important for Canadian trade policy. Chapter 2 relates these world events to Canada and discusses the past, present, and possible future of the Canadian economy. Most readers will want to look at these chapters, even if only to skim them. Chapter 3 makes the case for the gains from trade liberalization, reviews some of the most important quantitative measures of these gains, and concludes with an overview of Canada's past and present trade policy. This chapter can be skipped by those who are already convinced of the gains from further trade liberalization, although the brief history of trade policy may still be of interest.

Part II begins with a review of Canada's trade options. The length of Chapter 4 reflects our feeling that all of the available options, including the inward-looking nationalist option, should be given careful consideration. Chapter 5 looks in detail at the option that seems to us to be "the only game in town": a major increase in bilateral trade liberalization with the United States. Such an arrangement has been given many names, but we prefer to use the term that would be used under Article XXIV of the GATT — a free trade area — while recognizing, of course, that *totally* free trade is an unachievable ideal. The discussion of the piecemeal and comprehensive approaches to bilateral trade liberalization is critical to anyone wishing to follow the current policy debate.

Part III deals with concerns and issues. Chapters 6 and 7 discuss the underlying concerns many Canadians have that a closer trade association with the United States will seriously compromise our political, cultural, and economic integrity. For many people, these will be the most interesting chapters, and they are pretty much self-contained. Although we cannot pretend to have said the last word on these issues, we have gone much further than the mere assertions with which many other commentators have been satisfied. Chapters 8 and 9 deal with what we think the debate should be about now: not "Should we have trade liberalization with the United States?" but, "How should we go about achieving it?" Many difficult issues involving economic adaptation and political sovereignty will arise and will have to be handled carefully. What in-

dustries should be included and what excluded? How do we protect our ability to follow certain desirable national policies within the terms of the agreement? The ways in which these nitty-gritty issues are handled in the details of the agreement will determine whether many of the grand Canadian worries about political and cultural independence and economic integrity will be realized or avoided. These issues are what Canadians should be discussing in detail now.

Chapter 10 draws the argument together. It concludes by stating the view that a Canadian initiative now would not be the act of desperation that some see in it, but, instead, would be an act of confidence in the capacity of our economy to cope with the severe challenges facing it — a confidence that, after looking carefully at the evidence, we feel very strongly.

Richard Lipsey
Toronto
April 1985

PART I

Policy Background

1

Backdrop: The Changing Global Economy

Irreversible forces of technological, economic, and social change are sweeping through the world. They are transforming economic relationships, altering long-held expectations for national economic prospects, and putting pressure on established economic institutions.

The North American economy is not immune. The United States is increasingly preoccupied with the competitive challenges its industries face from abroad, and the imbalances created by its domestic macroeconomic policies. Canada, in recent years increasingly dependent on the U.S. market, faces similar challenges and imbalances. The turbulent international environment is of particular concern to Canada because it is the only established industrial nation, other than Australia, without guaranteed access to a market of more than 100 million people.

The Global Trading Environment

The global trading environment is being reshaped by major forces of economic change. Many of these emanate from the developing countries, particularly because of the rapid growth of their industrial capacity. A number of the so-called "newly industrializing countries" (NICs), including South Korea, Brazil, and Mexico, as well such Mediterranean countries as Spain and Greece, are developing heavy industries. These manufacture capital goods, such as steel and transportation equipment, that were formerly produced mainly by the advanced industrial countries in Europe and North America.

A comparison of key economic and industrial growth indicators is apparent in Table 1. The NICs have now reached levels of production sufficient to reap major economies of scale and, hence, are able to compete with basic heavy industries in the industrial countries. Furthermore, a host of lower-wage developing countries, including China, Thailand, Malaysia, the Philippines, and India, are expanding production in textiles, footwear, and clothing, and in labor-intensive, light manufactur-

ing such as consumer electronics. This is formidable, and in the long term often unbeatable, competition for similar industries located in countries — such as the United States and Canada — that have relatively high labor costs.

TABLE 1
Industrial and Economic Indicators, Selected Countries, 1970–82
(average annual percentage change)

	GNP per capita[a]	Consumer prices	Gross domestic investment	Exports	Manufactured output
Canada	3.1	9.3	3.3	4.0	2.5
United States	2.2	7.3	1.3	5.6	2.4
Japan	6.1	6.9	3.3	8.5	6.6
Argentina	1.6	136.0	1.0	8.3	−0.2
Brazil	4.8	42.1	6.5	8.8	7.8
South Korea	6.6	19.3	11.0	20.2	14.5

[a]Growth of GNP per capita is for the period 1960–82.

Source: *World Development Report, 1984* (New York: Oxford University Press for the World Bank, 1984).

In spite of having small local markets, many of the NICs have succeeded in developing fast economic growth rates by pursuing export-oriented strategies based on relatively low industrial wages by world standards — but not by local standards — high savings rates, and aggressive marketing practices.

The competitive challenge of the NICs has increased since the 1981–82 world recession because of the debt problems many countries face. Debt which seemed manageable during the 1970s, when inflation was high and credit cheap, became a serious burden when world interest rates began to soar in 1981. Since most debt was denominated in U.S. dollars, the foreign exchange necessary to service it often had to be acquired by harsh austerity measures. Imports were slashed, reducing markets for the industrial countries' exports, and exports were pushed. Natural resources were often sold at bargain prices on international markets by nations desperate for foreign exchange, which helped to hold down international commodity prices.

Along with industrialization of developing countries, technological

rivalry among the industrial countries is intensifying. Transportation and communication costs continue to decline and the international exchange of services is becoming more important. Taken together, these developments are reshaping global patterns of comparative advantage.

Trade Liberalization

By far the most important development in international economic relations in the post-World War II period has been the widespread reduction of tariff barriers accomplished by the General Agreement on Tariffs and Trade (GATT), to which most of the world's important trading countries are signatories. The high tide of tariff restrictions reached during the 1930s has receded under the influence of the GATT and, as a result, the world's economies have become increasingly intertwined through a set of complex trading relations. The United States, for example, has gone from a virtually closed economy, with exports and imports equal to only 4.2 percent and 4.4 percent, respectively, of its GNP in 1936, to an open economy that has integrated into the world economy, with exports and imports in 1980 equal to 13 percent and 11.7 percent, respectively, of its GNP.

Not unrelated has been the growth of large, tariff-free, internal markets. The U.S. market now contains 235 million people. The European Community (EC) is a tariff-free market of 270 million — at least for nonagricultural goods — and, when the countries of the European Free Trade Area (EFTA) are included, the integrated European market contains over 300 million people. With the accession of Spain and Portugal to the EC in 1986, the combined population of the entire trading block will be 350 million. The Japanese market, although smaller, contains more than 120 million people. Canada and Australia are the only advanced industrialized countries that lack unimpeded access to a market of more than 100 million people.

The Rise of Protectionism

The slowness of the world recovery since 1982 has made legislatures in many industrial countries much more protectionist-minded than they were a decade ago. An important feature of the recent rise in protectionism is that it has not been characterized by the imposition of tariffs so much as by the increasingly widespread use of nontariff barriers to trade (NTBs). GATT negotiators spent much effort codifying allowable procedures for "contingency measures": for antidumping duties dur-

ing the Kennedy Round of negotiations in the 1960s, and for countervailing duties during the Tokyo Round in the 1970s. There seems little doubt that this codification has been followed by an increase in the use of NTBs as barriers to trade. These have partly offset the trade-increasing effect of the GATT-inspired tariff reductions, and they have changed the regime of trade regulation from clearly stated tariff rates that were known in advance to one that former Canadian GATT negotiator Rodney Grey has called the regime of "contingent protection".[1]

Although there is no doubt about the rising use of NTBs, there is debate about the reasons for this development. Some feel that, with the rise of protectionist sentiment, NTBs were bound to be increasingly resorted to and that GATT codification restrained their use. Others feel that the GATT codification itself exerted a perverse influence.[2] Whatever the explanation, what matters is the reality of the growing use of NTBs.

The United States has been a very important player in the rise of protectionism. There are several reasons for this:

- The United States is unhappy with the degree of trade restrictions that it perceives in the policies of Japan and the EC. As a result, it has sometimes resorted to retaliatory measures. Third-country bystanders, such as Canada, are in danger of being caught in the crossfire, and so being hurt by these measures.
- The high value of the U.S. dollar has put U.S. exporters and producers who compete with imports under heavy competitive pressure. This has led to the revival of strong protectionist pressures on the U.S. Congress.
- There have been changes in U.S. perception of problems associated with international trade. Rodney Grey puts these as follows:

> first, the concern to provide better protection for U.S. producers against "unfair" import competition; secondly, the consequent focus on the concept of injury...as central to trade relations law; and, thirdly, of broad and general impact, the switch in the emphasis or balance in the U.S. commercial policy system from the provision of protection mainly by a structure of tariff rates, to the provision of protection by

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[1] R. de C. Grey, "A Note on U.S. Trade Practices," in W.R. Cline, ed., *Trade Policy in the 1980s* (Washington, D.C.: Institute for International Economics, 1983), p. 248.

[2] Ibid. The contrary position is taken by J.H. Jackson, "Perspectives on the Jurisprudence of International Trade: Costs and Benefits of Legal Procedures in the United States," *Michigan Law Review* 82 (April-May 1984): 2601-2618.

a complex system of "contingency" measures or measures affording "stand-by" protection.[3]

The International Significance of U.S. Macroeconomic Policies

U.S. macroeconomic policy in the 1980s has combined an expansionary fiscal policy, with its associated demand to borrow large sums of money to cover the deficit, and a contractionary monetary policy, with its associated high interest rates. As a result, the U.S. economy has sucked in enormous amounts of capital from the rest of the world. Associated with these policies has been a very strong U.S. recovery since the 1981–82 recession. This strong recovery, together with a very high real return currently being earned on investments in the United States, has added to the attractiveness of the U.S. market for foreign capital. The need to obtain U.S. dollars, in order to lend or invest in the United States, has forced that currency to high levels on foreign exchange markets. In turn, the high U.S. dollar has discouraged exports and encouraged imports. This has created a balance of payments deficit on the current account — without which the inflow of foreign capital could not occur.[4]

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[3] R. de C. Grey, *United States Trade Policy Legislation: A Canadian View* (Montreal: Institute for Research on Public Policy, 1982), pp. 5–6.

[4] Canada's balance of payments accounts record the transactions that involve the exchange of Canadian and foreign currencies. These transactions are divided between current and capital accounts, each of which is then subdivided according to the following scheme:

Current Account			Capital Account	
Merchandise	Services		Short term	Long term
	Traded services (other services)	Capital servicing (interest & dividends)		

Items that are currently traded are tangible goods, which are recorded under the merchandise account, and traded services such as insurance, shipping, and banking services, which are recorded under the "other services account". These items respond to changes in the exchange rate. The other set of items under the services account are the payments of interest and dividends that depend on the capital stocks that are owned at home and abroad. The capital account records movements of capital. These may be classified in a number of useful ways. The one that is used above distinguishes the capital according to its investment term. Short-term capital is highly mobile and ready to move into or out of a country at short notice. Long-term capital is committed for a longer period of time and will not move in response to short-term fluctuations in the relative advantages accruing to funds denominated in particular currencies.

The link between current and capital accounts in a country's balance of payments is often misunderstood in interpreting current U.S. policy and in assessing its future economic prospects. Leaving aside the relatively small influence of central-bank intervention in foreign exchange markets, any deficit or surplus on the capital account must be matched by an equal and opposite deficit or surplus on the current account.

Putting the point in the words of Paul Volcker, Chairman of the U.S. Federal Reserve Board, "the essential counterpart of a net capital inflow is a massive trade and current account deficit."[5] Thus, if the United States is to be a net importer of capital, which implies a surplus on the capital account, it must have an equivalent deficit on the current account. It follows that as long as the United States borrows a given amount abroad to cover the domestic budget deficit, it must have the equivalent current account deficit. Any special measures of the type being considered in early 1985 — emergency tariffs or import surcharges, for example — that appear to reduce the current account deficit must either reduce capital inflows or merely further drive up the value of the dollar until the original current account deficit is reestablished.[6]

The Future Outlook

The three broad forces that we have outlined — the rise of the NICs, the growth of protectionism, and the U.S. current account deficit — are likely to dominate the international scene for some time to come. Let us look at each of these in turn.

The Challenge of the NICs

The increasing industrial presence of the NICs is irreversible and Canada must adjust to it. If we try to freeze our present industrial structure, we will end up being involved in growing and, in the end, losing competition with these countries. If we move "up market" to high-wage, high-value-added types of production, the NICs will become an asset in terms of growing markets for our commodities rather than a threat in terms of lower-cost sources of the goods we produce.

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[5] P.A. Volcker, Statement by the Chairman, Board of Governors of the Federal Reserve System, before the United States Congress, Senate Committee on Foreign Relations, Subcommittee on International Economic Policy, Washington, June 15, 1984 (reprinted in *Federal Reserve Bulletin* 70 [July 1984]: 569).

[6] On this point, see, for example, P.A. Volcker, Statement by the Chairman, Board of Governors of the Federal Reserve System, before the United States Congress, Senate Committee on Foreign Relations, Washington, February 27, 1985.

The Rise of Protectionism

Protectionist sentiment is likely to be around for a long time. No one can say it is irreversible, but Canada would be ill advised to base its long-term trade strategy on the assumption that it will soon pass. While international sentiment increasingly favors the convening of a new GATT round to deal with the issue of NTBs and to resist the rise of protectionism, results may be disappointingly small and are likely to be a long time coming.

The U.S. Current Account Deficit

The set of forces that has created the U.S. balance of payments deficit is reversible. But no one is able to predict when the reversal will occur. There are two main scenarios leading to this reversal, and decisions that have yet to be made will determine which of these will be played out.

Scenario One: The Deficit Is Reduced

The first scenario is brought into play if the U.S. Congress enacts significant deficit reduction over the next few years. As the deficit is reduced, the U.S. government's borrowing requirements fall correspondingly. This will allow interest rates to fall.

The flow of foreign capital into the United States will fall off because total U.S. borrowing will be reduced and because U.S. interest rates will be lower. The reduction of the inflow of capital into the United States will reduce some of the pressure on the U.S. dollar and its value will fall on the foreign exchange market. The decline in the value of the dollar will encourage U.S. exports and discourage imports. If these changes go far enough, the United States will end its temporary role as a net importer of capital and, as the capital account comes into balance, so also will the current account.

This chain of events is no mere classroom exercise. It is essentially a playing in reverse of the events of the last few years, where high deficits, high interest rates, and high inflows of foreign capital have pushed up the value of the U.S. dollar and led to a large current account deficit.[7] No one can be quite sure when, or if, Congress will reduce the U.S. budget deficit, but the forces that deficit reduction will put into play are clear enough.

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[7] Consider the foreign exchange market, where Canadian dollars are traded for foreign exchange. Those who buy foreign exchange offer Canadian dollars in return. Those

Should this occur, today's position will be reversed. The United States will enjoy an export boom, its import-competing industries will be successful as well, and the present protectionist sentiments will diminish. (However, Americans' real income will fall because of the need to export more and more goods to pay the servicing on past borrowing, but the level of economic activity will boom.)

Scenario Two: The Deficit Is Not Reduced

The second scenario occurs if Congress does not get the deficit under control. This means that the deficit, and the foreign borrowing needed to finance it, continues. In a very few years, U.S. foreign debt will come to dwarf that of the current large debtor countries. As this situation develops, the cost of servicing the foreign capital must grow until, finally, the annual outflow of interest and dividend payments exceeds the annual

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who sell foreign exchange are obtaining Canadian dollars in return. The relation between the balances on current and capital account follow from the fact that every unit of foreign exchange bought by someone must be sold by someone else so that total purchases of foreign exchange must equal total sales of foreign exchange. We now separate the reasons for *buying* foreign exchange into two groups. First, foreign exchange is bought for the purpose of paying for foreign goods and services — including interest and dividends on foreign capital. These are current account purchases. Second, foreign exchange is bought in order to transfer capital abroad in the form of loans, equity, direct investment, bank accounts, and so on. These are capital account purchases. Now look at *sales*. Foreign exchange is sold in return for Canadian dollars in order to make current account transactions, payments for Canadian goods and services, and capital account transactions, thus moving capital into Canada. (As in the text we ignore the relatively minor dealings of the central bank.)

So if more Canadian dollars are bought to move capital into Canada than are sold to move capital out — the situation in the late 1970s — this money must have come from somewhere, the only source being that more Canadian dollars are sold in order to pay for foreign goods and services than are bought in order to pay for Canadian goods and services. The imbalance on capital account can only occur of there is an equal and opposite imbalance on current account. Without the latter, the money would not have been available for the former.

Using algebra, the relation is easily seen. Let P be total purchases of foreign exchange and S total sales, and let subscripts c and k stand for current and capital account items. Now we have $P=P_c+P_k$ and $S=S_c+S_k$, which merely divides all purchases and sales into these two categories. But since for every buyer there is a seller, we have $P=S$, which is the same thing as $P_c+P_k=S_c+S_k$. Now transferring terms to get the two account balances, we have $P_c-S_c=S_k-P_k$. This says that any excess of purchases over sales on current account must be matched by an equal excess of sales over purchases on capital account. This is no mere tendency, and no mere theory; it is a fundamental accounting relationship that must be true at each and every moment in time.

inflow of new capital. Then the same adjustment mechanism as we earlier outlined comes into play.[8]

How Long and How Much?

What time spans are involved? Some attack on the deficit could come soon, but a reduction sufficient to reduce foreign borrowing so as to reverse the recent increase in the U.S. dollar is at least two or three years away. If the budget deficit is left uncontrolled, the second mechanism — where outflows of interest and dividends earned on the stock of foreign capital become large relative to the inflow of new capital — could take from five to ten years to put significant downward pressure on the U.S. dollar.[9]

How far will the U.S. dollar fall in value? If the deficit were the only reason for the capital inflow into the United States, we could expect the adjustment mechanism outlined above to go all the way to producing a large current account surplus. Put in more prosaic language, the United States will have to export more merchandise than it imports, in order to earn the money necessary to service the large foreign holding of U.S. debt and equities. But the United States is a very attractive location for investment for many reasons. It is quite possible, therefore, that the United States will continue for some time to be a net importer of capital, even after the contribution of the budget deficit is removed. If this is so, the adjustment mechanism will reduce, but not totally eliminate, the U.S. current account deficit.

So all in all, we must allow for the possibility that the high U.S. dollar, and the current account deficit and strong protectionist sentiments that accompany it, will persist for some time. We must also allow for the fact that the inevitable reduction in the current account deficit may not go all the way to a current account surplus for many years.

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[8] Foreigners who receive the interest payments sell U.S. dollars to buy domestic goods. As a result, the dollar falls in value, and a large merchandise surplus opens up to cover the service account deficit. The rest of the play is the same as in the previous case, except that U.S. living standards fall much further because the debt-servicing requirements are so much larger in this case.

[9] In a market where speculative forces are so important, only a rash person would claim to know when the dollar is likely to tumble enough to remove the U.S. current account deficit. All that can be said with confidence is that the major contribution of the U.S. deficit to the high value of the dollar will disappear probably somewhere between two and seven or eight years from now — quicker if the deficit is brought under control, and slower if it is not.

The upshot is that Canadian policymakers would be ill advised to base their policies on the assumption that the causes of current U.S. protectionist sentiment will evaporate within a fairly short period of time.

The Japanese Trade Surplus

Our second glimpse into the future takes less time to describe, although it is hardly less important. Japan is currently running a large current account surplus that provides funds to invest abroad, particularly in the United States. Sooner or later, Japan will become a mature creditor country: one that takes in each year more earnings from its past foreign investments than it lays out on new foreign investments. When this happens, Japan must become a net importer, rather than a net exporter, on the merchandise and traded services accounts. When Japanese residents seek to repatriate their foreign investment income, this puts upward pressure on the yen. Indeed, the yen must rise in value sufficiently to open up a merchandise and traded services account deficit — which means that the excess of imports over exports of goods and services is paid for by current earnings on past investments. The rise in the value of the yen will make it easier for foreign exporters to sell in Japan, so that the country gradually will become one of the world's great markets for foreign exporters. It is hard to predict when this second event will occur since its timing depends on many aspects of Japanese policy as well as the savings behavior of Japanese residents. But come it must. Each year, the earnings on past investments rise and, sooner or later, they must exceed the volume of new investments. When that occurs, Japan's merchandise and traded services accounts must go into deficit.

It is possible that these two developments will take place at more or less the same pace and over more or less the same time period. Whether or not they are synchronized, however, the change in international relationships that each will bring will be momentous. The consequences will be great not only for the United States, but also for all important trading nations, including Canada.

Conclusion

Along with rapid technological change and growing interdependence, the industrialization of developing countries and current account imbalances are reshaping the global economy and straining the world trading system. The inevitable expansion of exports by lower-income developing countries, notably China, and the maturing industrial capa-

bility of the NICs are creating challenges for the industrial countries that cannot be avoided. Eventually, there will be a realignment of exchange rates and the flood tide of U.S. trade deficits will be reversed. But the pattern of world trade will be permanently altered. Protectionism might decline in the United States and Europe when Japan becomes a substantial importer, but this will depend on whether the industrial countries resist or adapt to the competitive pressures of the NICs. The next chapter examines Canada's prospects in this shifting and turbulent global economy.

2

Canada's Troubling Prospects

In some ways, the consequences of the global forces of economic change are nowhere better illustrated than in the change in Canada's prospects in the last few years. Until the early 1980s, Canada was perceived by many to have better prospects than nearly any nation in the world. "A solution in search of a problem" was often the way outsiders described Canada. But Canada's long-term prospects have been diminished by slow world recovery, rising international competition, rising protectionism, and internal policy errors generated by an unwillingness to accept the cost of Canadian adjustment to the long-term changes under way in the world economy. Major changes in policy, to reshape Canada's economic prospects are now required.

Canada's Good Record

In spite of some cyclical ups and downs, the Canadian economy in many ways has performed quite satisfactorily during the postwar period. Between 1950 and 1984, the country's real GNP grew by 316 percent. Population increased 83 percent to 25 million from 14 million, and real output per capita grew by 127 percent. Canada was in the forefront of the industrial nations in its job creation. The number of employed persons rose to nearly 11 million in 1984 from 5 million in 1950. There were a few periods when unemployment rose from one year to the next. But with rare exceptions, this rise in unemployment was not the result of a contraction in the number of jobs but, rather, of the growth in jobs falling somewhat short of the growth in the numbers wanting to work.

Canada's trade performance was also good. Measured in 1984 dollars, the value of exports rose to $112.5 billion in 1984 from $12.7 billion in 1946. The composition of Canada's exports has moved progressively away from traditional primary and semifabricated products in the direction of more fully manufactured products (see Table 2). During the 1960s, for example, manufactured goods dramatically increased the

share of total Canadian exports to 30 percent from 8 percent. Although the major contributing factor after 1965 was the increase in exports of automobiles and auto parts under the autopact, this movement was also partly the result of the economy's successful adjustment to the major tariff cuts instituted by the Kennedy Round of negotiations under the General Agreement on Tariffs and Trade (GATT). At that time, pessimists argued — just as they still do today — that the economy would be harmed by the removal of tariffs that protected the domestic market for domestic producers. Instead, when the Kennedy Round of tariff cuts occurred, many firms rationalized by going into fewer product lines that could be produced in longer production runs. They then found that the resulting lower costs allowed them to increase their exports. The Canadian economy adjusted to a bout of significant trade liberalization, almost without being noticed by anyone outside of those who were immediately affected. The economy emerged from the adjustment with more manufactured exports and increased living standards.

TABLE 2
Commodity Composition of Canadian Exports, 1960–84
(percentage)

	1960	1970	1980	1983	1984
Food and agriculture	18.8	11.4	11.1	11.6	9.7
Crude materials	21.2	18.8	19.8	15.9	15.8
Fabricated materials	51.9	35.8	39.4	33.3	32.0
Manufactured end products	7.8	33.8	29.4	38.9	42.1
Special transactions	0.3	0.2	0.3	0.3	0.4
Total	*100.0*	*100.0*	*100.0*	*100.0*	*100.0*

Sources: Economic Council of Canada, *The Bottom Line: Technology, Trade, and Income Growth* (Ottawa: Supply and Services, 1983); and Statistics Canada, *Summary of External Trade*, Cat. no. 65-001, (December 1984), p. 19.

In the early 1970s, troubles began for most of the world's economies. The first oil shock, in 1973–74, ushered in the "Great Stagflation" of the mid-1970s. Around the turn of the decade, the belated decision of most western governments to attack inflation with monetary restraint turned a normal downturn into the "Great Recession" of the early 1980s. This is a recession from which Canada, in contrast to the United States, has yet to recover fully.

The late 1970s was a prosperous period for Canadians for three main reasons. First, and most important, it was a good time for exports: the terms of trade were favorable for Canada.[1] As a result of high prices for our exports relative to the prices of our imports, domestic consumption rose faster than the rise in domestic production.

Second, this was a period of high investment that was led by the energy sector, including provincial utilities producing electricity. Most of this investment was financed by foreign borrowing, and its effects on the Canadian economy were initially expansionary.

Third, compensation for employed Canadians rose much faster than did total output. For example, disposable income — the amount Canadian households have available to spend or to save after paying income taxes — rose about twice as fast as did total output. Since, in the long term, it is total output that determines what is available for consumption, this rate of increase in disposable income was not sustainable. However, at least two forces allowed this condition to persist through the latter part of the 1970s. The first was that the favorable terms of trade permitted more to be imported for a given amount of exports. The second was that much of the investment during the period was financed by borrowing abroad. This allowed both consumption and investment to remain at high levels. The gap between our spending on both consumption and investment, on the one hand, and our production, on the other hand, was made up through foreign borrowing — which entailed, as it must, a current account deficit.

Signs of Trouble

Even during this favorable period, there were signs of difficulties ahead:

- Expectations of rising compensation became ingrained at a time when there was a slowing in the rate of growth of output — the very output that would have to sustain these expectations in the long term.

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[1] "Terms of trade" refers to the relationship of the prices of what we export to the prices of what we import. "Improving terms of trade" refers to situations where our export prices are rising relative to our import prices. In such situations, our standards of living can rise because every unit of imports requires that fewer and fewer units of exports be sent abroad in return. Thus, out of any given total national production, there is more home production available for domestic consumption, after paying for a given total of imports.

- Although real per capita GNP rose every year, its rate of growth was much slower than in any previous decade since 1945. During the whole decade from 1975–85, it rose by only 8 percent — a rise of less than 1 percent per year.
- Productivity rose hardly at all during this period. This was a worrying development since output per person employed is what determines individual living standards in the long term.
- Although there were fluctuations, the trend of unemployment was upward during most of the period. Already as high as 7 percent in 1975, unemployment rose to 13 percent in 1981.
- Inflation, although temporarily slowed during the existence of the Anti-Inflation Board, began to rise again in the late 1970s. By 1981 it had reached 14 percent.
- The federal government's structural deficit — what the deficit would be if full employment were attained and there was low inflation — rose during the period. The rise during the 1974–76 period was understandable as part of the decision to insulate Canadians against the recession. A prudent stabilization policy requires, however, that the deficit be reduced as the economy recovers. This did not happen and, as a result, a long-term structural deficit developed. Major contributing factors were the permanent tax cuts introduced during the mid-1970s, and the decision to index both the personal income tax system and individual transfers to reduce erosion by inflation.

Starting in 1974–75, Canada began to run large current account deficits as well as experiencing outflows of direct investment, as can be seen in Table 3. From 1978 onwards, the outflow of direct investment was about 1 percent of GNP and represented Canadians' decision to locate productive facilities in foreign countries rather than at home. At the same time, the financing of much domestic Canadian investment through foreign loans caused a large inflow of debt capital. On balance, Canada was a net importer of capital throughout the period. Just as present U.S. capital imports cause a high U.S. dollar and require a current account deficit, so in the mid-1970s the Canadian dollar was at a high value and the current account was in deficit by the amount of the net capital inflow.

Most of these capital inflows were the result of a series of independent decisions by private and public Canadian enterprises. At the end of the 1970s, however, these flows were reinforced by government policy. The National Energy Program led Canadians to buy out many foreign assets just before their market value fell as a result of the collapse

of the oil boom, and to borrow the necessary funds from abroad, just before interest rates soared. With hindsight, the policy of substituting debt for equity just as energy prices were to sag while interest rates soared can be seen as a costly error. Whatever its apparent wisdom at the time, the policy reinforced the tendency for Canadian development to be financed heavily by foreign debt capital while much Canadian equity went abroad.

TABLE 3
Net Direct Investment and the Current Account Balance, 1960–84
(millions of dollars)

	Current account balance	Net direct investment[a]
1960	−1,233	620
1961	−928	480
1962	−830	400
1963	−521	145
1964	−424	175
1965	−1,130	410
1966	−1,162	785
1967	−499	566
1968	−97	365
1969	−917	350
1970	1,106	590
1971	431	695
1972	−386	220
1973	108	60
1974	−1,460	35
1975	−4,757	−190
1976	−4,109	−889
1977	−4,334	−265
1978	−4,917	−2,190
1979	−4,840	−1,800
1980	−1,114	−2,350
1981	−6,065	−11,300
1982	2,665	−1,850
1983	1,686	−2,500
1984	1,955	−1,645

[a]A positive number indicates capital imports; a negative number capital exports.

Source: Statistics Canada, CANSIM Matrixes D50560, D50564 and D60555.

Diminished Prospects

During the 1981–82 recession, Canada experienced the largest percentage drop in output of any nation in the Organisation for Economic Co-operation and Development (OECD). In the slow recovery that followed, the forces that had been so buoyant to the economy in the late 1970s disappeared. One of the reasons was that the Canadian terms of trade changed in an unfavorable direction. This change lowered the real income that could be supported by any given level of output. Because it took time for income expectations to adjust, money wages continued to rise rapidly for longer than market conditions could support such increases. During the recession, inflation fell more slowly in Canada than in the United States, and the resulting high level of money costs worsened the competitive positions of some exporting industries.

In a related development, both the forest and mining industries entered a period of depression. The combination of high interest rates and low inflation reduced demand to hold inventories of resource commodities. Weak investment spending in most countries other than the United States lowered global demand for basic materials, as did the development of new materials that replaced traditional natural resource products. The depression was also due, in part, to increasing competition from producers located in developing countries, some of whom were willing to export natural resources at bargain prices in order to earn the foreign exchange that was required to service their foreign debt. The high value of the Canadian dollar relative to all currencies other than the U.S. dollar gave competitors in developing countries an edge over many Canadian products.

The energy boom came to a halt during this period as well. Investment in petroleum and other energy sources, such as electric power generation, fell substantially. Although the western provinces were particularly hard hit, the effects were felt everywhere.

The behavior of productivity has been something of a puzzle. Canada's productivity growth is at a low level, in part because of the low level of capacity utilization that existed in Canada in the 1980s, but also because of the failure of new investment in productivity-increasing equipment to recover as the economy moved out of the recession.

Indeed, the behavior of the entire Canadian economy during the recession of the early 1980s was unique and troubling. This was the first recession in the postwar period that was deeper, and more prolonged, for Canada than for the United States. Canada's current sluggish recovery, while the United States rapidly approaches full employment, is

unprecedented. One of the main reasons for this sluggishness is the failure of investment to recover as quickly as it has in past recessions.

What are the reasons for the slow recovery of investment? In addition to the changes in the global economy discussed in Chapter 1, several factors peculiar to the Canadian economy can be identified:

- Canadian firms continue to make substantial direct investments in the United States. Not only is the flow continuing at present, but surveys of investment intentions made by Professor Don Daly of York University show that most successful Canadian firms intend to increase substantially the amount of their investment in the United States in the near future.[2]
- Several Canadian industries are in severe difficulties and only exist in their present state by virtue of government support in the form of direct grants or subsidies, or import restrictions on competing foreign products.
- The predominance in the Canadian economy of resource-based industry that is suffering from reduced export demand, has reduced the rate of return on investment, especially relative to that in the United States.
- Canadian firms have experienced a high degree of indebtedness because of debt acquired prior to the recession, when credit appeared to be cheap and inflation was expected to continue for some time.
- Continued high interest rates in Canada, and the sensitivity of consumer demand in Canada to interest rates, undoubtedly acts as a depressant on Canadian investment.
- Under the impact of prolonged inflation, high interest rates, and some new government expenditure initiatives, the federal budget deficit is growing significantly, while interest payments on the federal debt account, by early 1985, for more than one-third of all federal revenues.

Implications of Changing Global Trends

The three international trends outlined in Chapter 1 have had an unfavorable impact on Canada. Let us examine this impact in some detail.

The Newly Industrializing Countries

The growth of the newly industrializing countries (NICs) has meant severe competition in the more traditional types of manufacturing in

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[2] D. Daly and D. MacCharles, "Canadian Manufactured Exports: Constraints and Opportunities" (York University, Toronto, 1984, Mimeographed), p. 148.

Canada. All of the more advanced industrial countries, including Canada, find themselves fighting a rearguard action to protect industries that compete against the products of the NICs. In the long term, the maintenance of high living standards requires that Canada reduce its dependence upon high-labor-content industries such as textiles and footwear, except for specialty lines of production. The traditional labor-intensive industries can generate only limited revenue per person employed and, therefore, can survive in open competition only if wages are low or productivity growth is high. If they survive through protection and subsidies, these industries still create only low value and thus contribute low amounts to the total Canadian product. The maintenance of a high and rising level of Canadian output requires that these industries be replaced by higher-value-added product lines. Lower-value-added products can then be bought more cheaply from the NICs while Canadian labor is diverted to the higher-value-added activities. The alternative is to stay in close competition with the NICs and to hold down living standards generated in the protected sectors of the economy. An important point to note is that, over the long term, competition with the NICs and with other low-wage countries in traditional industries is something that can persist only with policy intervention to protect those products, employees, and industries at the expense of consumers and taxpayers elsewhere in the economy.

With its support for the GATT, Canada has aided some of these changes by allowing trade liberalization. Much Canadian industry has already reacted to the forces of trade liberalization by reducing the number of product lines and moving "up market" the lines that are retained. But with neither a mass local market nor secure access to viable export markets, Canada's ability to succeed in international markets with high-value-added manufactured goods and services continues to be constrained by the barriers that will remain when the Tokyo Round tariff cuts have been fully implemented. For this reason, even if Canada were willing to rationalize its production, its ability to adjust by providing alternative employment for workers displaced from the traditional labor-intensive industries is severely limited by its small market size.

Rising Protectionism

The growing mood of protectionism pervading the world and finding its way into Canadian policies also bodes ill for a major trading country such as Canada. The shift to a regime of "contingent protection" poses particular risks for investment in Canada.

Liberalization of trade provided by the GATT over the last 30 years

helped to usher in an unparalleled era of prosperity. If the world retreats to the "beggar-thy-neighbor" style of protectionism typical of the 1930s, living standards will be significantly reduced, particularly in countries, such as Canada, that generate a high proportion of their GNP through trade. It is, therefore, in our self-interest to do everything we can both to arrest the threatened slide into increased protectionism and to encourage further trade liberalization of the sort that has helped lead to Canadian prosperity over the past three decades.

Particularly worrying for Canada are changes in the U.S. attitudes toward trading relations. In 1984, 78 percent of Canadian trade was with the United States. For Canada to suffer a major increase in barriers to its trade with that country would be a very serious matter indeed. Canada has recently been implementing a series of contingent protection measures partly modeled on those in the United States. The discrepancy in the sizes of the two countries, however, means that the potential for U.S. measures to harm Canada vastly exceeds the potential for Canadian measures to harm the United States.

Consider just one example. With a more activist approach to countervail, the United States can place a countervailing duty on imports from Canada if it determines that the imported goods were produced with the help of any of a variety of Canadian government subsidies. The theory is that the countervailing duty merely offsets a subsidy not available to the U.S. firm that competes with the Canadian import, and so does nothing more than recreate the conditions of fair trade between firms in the two countries. Canada also has the power to levy countervailing duties against subsidized U.S. imports. But consider the position of two firms, both of whom feel they can supply their goods to the whole North American market. One firm wishes to locate in Canada. It will sell about 10 percent of its production domestically and export the remaining 90 percent to the United States. The second firm wishes to locate in the United States. It will sell about 90 percent of its production domestically and export only 10 percent to Canada. Now assume that both firms are offered a subsidy that may or may not be countervailable. One of the problems with countervailing duties is that, unlike tariffs, one can never be quite sure what is and is not today, and will or will not be tomorrow, determined by administrative finding to be subject to countervail. If the U.S.-based firm accepts the subsidy and this is subsequently found to be countervailable by the Canadian government, it risks having something around 10 percent of its production subject to duties. If the Canadian-based firm does the same, it risks having something around 90 percent of its sales

so affected. So the actual damage done by U.S. countervail is much more serious than the actual damage done by Canadian countervail. Furthermore, where the whole of the North American market is to be served, the incentive to locate production facilities in the United States rather than Canada is very strong.

As it is with countervailing duties, so it is with other forms of contingent protection. There are two reasons why contingent protection is particularly threatening to Canada. The first is the one we have just discussed. Because so much more of a successful Canadian firm's production is typically exported to the United States than is a successful U.S. firm's production to Canada, the contingent protection regime is particularly threatening to Canada. The second reason is that because so much Canadian policy, rightly or wrongly, is based on what can be broadly interpreted as subsidies, Canadian exports are particularly vulnerable to any aggressive U.S. interpretation of contingent protection.

U.S. Macroeconomic Policy

Current Difficulties

The strong U.S. dollar, resulting from rapid U.S. growth and the large U.S. budget deficit, has carried the Canadian dollar along with it. Although Canada's exchange-rate appreciation has not been quite as much as that of the U.S. dollar, the Canadian dollar has risen relative to all other important foreign currencies. As a result, Canadian goods are placed at a slight advantage competing with U.S. goods, but at a serious disadvantage competing with those of other countries, whether goods are being sold in the United States or elsewhere. Indeed, Canadian exports are doing well in the United States because of the buoyant U.S. recovery, but are in difficulty in many other markets. Even in the United States, Canadian exporters face strong competition from imports from other countries.

Future Improvements

When the adjustment in the U.S. dollar occurs — whether soon or not for some time — the two countries' currencies will depreciate on world markets. It will then be easier for Canadian goods to compete in the United States with goods coming from third countries. But if the Canadian dollar appreciates somewhat against the U.S. dollar, this will worsen our competitive position in the United States. It is important to realize

that these long-term changes in exchange rates and, hence, in competitive positions will occur. The only thing we can do is to adopt policies that take account of these effects. This argues for making changes as soon as possible. If we are going to make changes in our trading arrangements with the United States, the time to do so is now, while the Canadian dollar is weak against the U.S. dollar and our competitive position against U.S.-produced commodities is good.

One important consequence of the realignment of exchange rates will be to improve the competitive position of Canadian and U.S. goods in all other countries' markets. Canadian firms will find it easier to take advantage of these new opportunities in third countries if they have already cut costs as a result of greater trade with the United States.

Finally, consider the implications for Canada of Japan's development into a mature creditor nation. This could be as welcome to Canada as it will be to the United States. An expanding market will develop in Japan as the transition gradually occurs. One important concern is that Canadian firms should be in a position to take advantage of this market as it develops and not lose out in the early stages to countries that are able to enter the market quicker with more cost- and price-competitive products.

Long-Term Prospects

The lagging investment and persistent high unemployment that have appeared during the Canadian economy's recovery from the Great Recession of the early 1980s are symptoms of deep-seated underlying problems, both within the Canadian economy and in the ability to anticipate changes in the international economic environment. Uncertainty about future prospects for Canada's exports, combined with internal resistance to adjustments to major changes in international realities, have made the Canadian economy particularly vulnerable. Great care is needed in setting economic policies if Canada is to achieve desirable long-term goals while avoiding undesirable pitfalls. What are these goals and pitfalls, and how can we set about achieving the one while avoiding the other?

A Future to Be Avoided

If Canada continues with the status quo — keeping current policies unchanged — there are several strong possibilities for the shape of the economy in the year 2000.

- A major section of the economy could be specialized in providing high-

labor-content, "down-market" goods that compete with the products of whatever countries are newly industrializing at the time. Canadians will then either have to accept the relatively low standards of living that flow from the production of those goods or they will have to allow those industries to pay high wages by shielding them from foreign competition. In the latter case, the living standards of Canadians who buy high-cost, locally produced goods and whose taxes pay subsidies and low-interest loans will be lowered.

- Canada could well become a backwater: an inward-looking country that has turned its back on foreign trade by trying to encourage domestic production in order to reduce the importance of trade to the economy. This scenario is reminiscent of the Argentine experience. In the late 1920s, Argentina had a resource-based economy that was similar in many ways to that of Canada. The two countries had almost the same level of per capita real income. Argentina then chose an inward-looking policy based on protectionism and subsidization of local manufacturing. Since 1925, Argentina's real GNP per capita has grown by 65 percent while Canada's has grown by 265 percent.[3]
- Canada could experience a serious balance of payments problem, which it could be forced to "solve" with exchange controls that greatly restrict the ability of Canadians to buy what they want, to travel where they want, and to invest their money where they want.
- Canada could have a severe case of the economic disease currently called "eurosclerosis". Some of the characteristics of this disease are a high rate of unemployment, low rates of return of capital, low levels of investment, a rising tide of protectionism — because of a lack of confidence in the ability to compete internationally — and a series of subsidies, supports, and other policies — such as rent control — that greatly reduce the economy's real income and its capacity to adapt to change.
- Canada could find its living standards so low relative to those in the United States that subsidies to Canadian cultural activities would be dismissed as overly expensive luxuries, and people would begin to ask if the economic cost of a politically independent Canada was just too high.

Although historical analogies prove little about probabilities, they do reveal possibilities. There are very big stakes involved in getting economic policy on a correct course, as is illustrated by the experience of

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[3] *World Financial Markets* (Morgan Guaranty Trust Company of New York), February 1985.

the United Kingdom. Twenty-five years ago, that country had the second highest per capita GNP in Europe — only Luxembourg's was higher. Today, it has the third lowest in the European Community, coming ahead only of Greece and Italy. The current difficulties besetting European countries are much newer than those associated with the "British disease", but they carry cautionary tales for Canada: many of the symptoms that have accompanied Canada's unprecedentedly slow recovery from the recent recession are common to eurosclerosis.

Where Do We Want to Be in the Year 2000?

If Canada is to be economically successful in the year 2000, it will have to specialize industrially in "up-market" product lines that provide high values added, and so yield high living standards. This means that Canadian industry must not specialize in products that depend on a high content of low-paid labor. These products can only survive in open international competition if labor costs are low. For a small country such as Canada, achieving efficient levels of output requires specialization and rationalization. This means that many things must be imported. If Canadians are to be able to import, they must also be able to export. A high volume of foreign trade relative to our GNP must be characteristic of economic performance in the year 2000.

Canada can only profit from expanding markets in the NICs and other newly developing countries if it is prepared to trade with them. But we can sell our products to these countries only with difficulty if we are not prepared to buy their products in return. Thus, growth in mutually profitable trade requires that we do not allow public policy to freeze our present industrial structure so that Canada is producing the same goods as the NICs do. Instead, we must encourage adaptation so as to produce goods and services that are compatible with a growing volume of trade with these countries.

Economic prosperity is key to continued cultural and political independence. If Canada is to be a strong, politically independent country, in alliance with the other western democracies but secure enough to take its own line on international issues, it will need to reduce its economic vulnerability to politically inspired changes in trade policies abroad, and particularly in the United States. If Canadian culture is to be distinctive, while sharing common North American experience with the United States, it will require the support of a strong national economic performance. Preserving the Canadian cultural mosaic is costly, but doing so brings increased resilience, enabling it to survive of its own accord and

not be overwhelmed by U.S. culture.

The Canadian economy still has great potential. Natural resources are present in abundance, and best estimates suggest that many of the resource-extracting industries will continue throughout the rest of the century to be a source of strength to the economy, in spite of some unfavorable changes in market conditions.[4] Natural resources, however, may have lost permanently the preeminent place they have held historically as the major engine of Canadian economic growth.

Canada's well-trained and, by world standards, sophisticated labor force is also a major resource. There is evidence of first-class entrepreneurial ability in some, although not all, sectors of Canadian industry. Canada's university education system is quite good and has certainly improved in the postwar period. This is a critical source of the skilled technicians who will become the entrepreneurs and well-trained employees in the knowledge-based and services industries of the future. Thus, looked at from the point of view of natural and acquired resource endowments, there is no reason why the Canadian economy should not provide employment for its population at high and rising real living standards in the future.

Policy Instruments

How do we get from where we are now to where we want to be in the year 2000, and avoid being in many of the places that we do not want to be? Of course, most of the economy's successes and failures will depend on what the private sector does. But there are some beneficial things that public policy could do to help, and other potentially harmful things that public policy should avoid.

Since this monograph is mainly about trade policy, we do not need to spend a great deal of time discussing other policies. However, a brief survey may help to place trade policy in perspective as merely one part of a package of required policies. Although no one believes that establishing a good trade policy is sufficient for coping satisfactorily with Canada's problems, it is undoubtedly a necessary condition for doing so.

Fiscal and Monetary Policy

Fiscal and monetary policy set the background against which private-

[4] See Royal Bank of Canada, *Learning From Our Mistakes: A New Economic Policy Framework for Canada*, Submission to the Royal Commission on the Economic Union and Development Prospects for Canada (Montreal, July 1984).

sector activity creates wealth and income. In setting its monetary policy, the Bank of Canada must stick to its goal of maintaining a low inflation rate. Inflation has many harmful effects on the economy.[5] One of the worst is that it causes true business income to be overstated, with the effect that the corporate income tax is turned into a tax on capital. This lowers the already-low return on capital and provides an incentive for capital to migrate to countries with lower inflation rates.

With regard to fiscal policy, the budget deficit must be a prime concern. This is not the place to argue the exact timing, but many will agree that getting the deficit under control is the key objective of medium-term fiscal policy. Interest payments already take up one-third of total government expenditures. This leaves too little room for other government spending initiatives and creates the fear that, sooner or later, large deficits will be monetized and so be inflationary.[6]

Policies for Flexibility

Rather than enumerate all the possible policies, we merely note that it is important, first, to embrace policies that help the economy to adapt to the great changes that will no doubt occur in the world economic scene over the next decades and, second, to avoid policies that inhibit such adjustments.

This need for flexibility was the subject of the C.D. Howe Institute's submission to the Royal Commission on the Economic Union and Development Prospects for Canada, published as a *C.D. Howe Institute Commentary* in November 1983. There is thus no need to discuss these issues in detail here, and we content ourselves with one short quotation:

> Policy choices [should be] assessed with respect to their impact on the dynamic adjustment process. In this altered decision-making framework, traditional instruments that permanently shield economic activity from adjustment, such as restrictions on imports, loan guarantees to save ailing firms, and subsidies that prop up marginal industries, [should all be] evaluated in terms of the...cost of not redeploying that capital

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[5] Many of these harmful effects are discussed in R.G. Lipsey, *Inflation Monitor* (C.D. Howe Institute), November 1983.

[6] A detailed discussion of the reasons why the deficit must be a matter of concern is found in N. Bruce and D.D. Purvis, *Evaluating the Deficit: The Case for Budget Cuts*, Policy Commentary no. 4 (Toronto: C.D. Howe Institute, 1984). Detailed consideration of strategies for reducing the deficit can be found in E.A. Carmichael, *Tackling the Federal Deficit*, Observation no. 26 (Toronto: C.D. Howe Institute, 1984).

and labor into more productive activities.[7]

Industrial Strategy

One of the most important conditions for creating a dynamic, growing economy is implementing the right industrial strategy. We can distinguish three basic positions with respect to such a strategy. At one extreme is the "no-action-needed" approach, according to which the government needs to do nothing whatsoever. Industrial growth and development can be left fully in the hands of the private sector, which, as long as the government does not discourage it, needs nothing from the government by way of encouragement. At the other extreme lies the "microintervention" approach, where the government identifies winners and backs them with a host of favorable policies, including subsidized research and development, low-interest loans, favorable tax treatment, and relevant skills-training schemes. In between these two extremes is the "macroclimate" approach. In this view, the government creates a climate that is favorable to invention and innovation and then leaves it to the private sector to decide what risks are worth taking and where the funds for invention and innovation should be channeled.

We favor the "macroclimate" approach, and look to a hands-off policy at the individual-firm and industry levels where investment decisions are made, while pursuing an active policy to create a climate favorable to risk-taking. A number of policies that discourage the raising of risk capital, especially for small firms, could be removed, and new tax incentives for risky ventures and for research and development may have a place. Another key policy is support for a world-class university system. All too often, policymakers emphasize business research and development while forgetting universities, which are the basic source of discovery and invention. "High-tech" industries in the United States, for example, have tended to locate near some of the country's best universities because these can be relied on to provide the necessary supplies both of basic ideas and of highly trained personnel.

Trade Policy

We have already remarked that, because of the great significance of trade to the Canadian economy, getting trade policy right is a very important matter. A satisfactory trade policy is not sufficient for gaining

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[7] W. Dobson, R. Lipsey, and M. Smith, "Flexibility as the Best Protection," *C.D. Howe Institute Commentary* (November 1983), p. 5.

our long-term goals, but it certainly is necessary. Trade is so important to the Canadian economy that we do not see Canada getting anywhere near where we want it to be in the future unless the government manages to get the correct settings for its trade policy levers. Trade policy is the subject of the rest of this study, and we turn in the next chapter to a more detailed discussion of the importance to Canada of world trade.

3

The Gains from Trade

No one can seriously deny the critical importance of trade to Canada. No serious investigator has ever tried to show that Canada would be better off if it became self-sufficient. Our wheat, forest products, and mining industries, which sell most of their output abroad, would be crippled by a no-trade policy — to say nothing of those Canadian manufacturing firms whose products in 1984 accounted for more than 40 percent of Canadian exports. Thus, the conclusion that Canada gains greatly from foreign trade is generally accepted.

Some critics believe, however, that Canadian living standards could be raised by increasing current trade restrictions, and that they would be decreased by any further lowering of such restrictions. Such critics often accuse economists who advocate further trade liberalization of relying on purely theoretical arguments that have little practical validity. Yet, no one has ever produced a coherent argument, backed up by empirical estimates, to support the proposition that a major increase in trade restrictions would currently benefit Canada. Instead, what the critics of trade liberalization usually produce are isolated debating points. Too often, they simply fail to understand how the balance of payments adjustment process operates.

Those estimates that have stood up to careful scrutiny and criticism, that have been based on careful quantitative analysis of the impacts on all sectors of the economy, and that have calculated costs from real-world data, have shown gain to Canada from further trade liberalization. Various investigators differ on the magnitude of these gains, but as a relatively small economy, Canada can be expected to obtain long-term benefits from reciprocal trade liberalization, whether on a bilateral or multilateral basis.

In this chapter, we consider the sources of the gains that the Canadian economy gets from trade. We then discuss some of the measurements that have been made of the magnitude of the gains that could be obtained

from further multilateral or bilateral tra liberalization. Finally, we give a brief outline of past and present Canadian trade policy.

Sources of the Gains from Trade

Comparative Advantage and Scale Economies

The great nineteenth century British economist David Ricardo showed that there would be gains from trade arising from differences in *relative* costs of production among countries. His analysis deals with a simple case in which each industry's costs per unit of output are independent of the scale of output — that is, in economists' language, "costs are constant".

Some of the major gains from trade arise, however, from the fact that costs per unit of output vary with the scale of output. These cost variations are due to what may be loosely described as "economies of scale". They are a major reason why a small country, such as Canada, gains so much from international trade. Let us look at the sources of these economies.

- One important source relates to the size of plants. The larger the market that a firm is serving, the larger the plant that can be utilized to serve that market. Up to a point, the larger the plant, the lower its unit costs, because of the specialization that can be built into the plant's fixed capital equipment. These scale economies tend to be found most extensively in the processes used by such traditional heavy manufacturing industries as electricity generation, automobile production, steelmaking, and aluminum production.
- Of much more importance to modern-day Canada are the economies of larger production runs. There is a fixed cost in setting up the production equipment for a particular model of product. The length of the production run then determines the number of units of output over which the fixed costs can be spread. The longer the production run, the lower the unit cost of production and the lower the price that is needed to recover the fixed, as well as the direct, costs of production. The length of production run, in turn, depends on the size of the market. When producing for a protected home market, Canadian firms have typically found it necessary to produce the whole possible range of allied products, which can easily stretch into hundereds of different associated product lines. When trade has been liberalized, one common reaction has been to specialize in a smaller range of products, leaving the rest of the product

range to be served by imports. On this smaller range of products, produced for the domestic market as well as for export, the production runs can be much longer and, hence, unit costs much lower.

- A further economy arises from product specialization. When the range of product lines is narrowed, more attention can be, and often is, devoted to improving the characteristics of the products that are produced.
- Another cost gain comes from so-called "dynamic considerations". The phenomenon of learning curves is well established in many industries: costs fall as the total amount produced increases. The higher the rate of output, the faster a firm moves down its learning curve and, hence, the lower its costs at any point in time.
- It is commonly argued that Canada has a lower rate of adoption of known improvements in technology than do other industrial countries.[1] If this is related to the length of time that it takes to write off the value of older technology, then the higher the rate of output, the faster the rate at which new technology is introduced and the lower will costs be at any point in time.
- There can also be important economies of scale for firms in activities such as product design and marketing, sometimes referred to as "economies of scope". Access to large markets may be a critical factor influencing the capability of firms to exploit such growth opportunities.[2]

The Role of the Exchange Rate

People who worry about trade liberalization often wonder if we will be able to hold our own against lower-wage countries on the one hand and higher-productivity countries on the other. Many of these concerns exist because the world has yet to learn fully the lesson taught by David Ricardo. Ricardo asked, "Can there be mutually advantageous trade between various types of countries? Can rich and poor countries, high- and low-productivity countries, and high- and low-wage countries trade with each other to their mutual advantage?" Ricardo's answer was an unequivocal "Yes", and the reason he gave is as valid today as it was in the early nineteenth century when he first gave it. His reason was

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[1] See D. Daly and S. Globerman, *Tariffs and Science Policies: Applications of a Model of Nationalism*, OEC Research Studies no. 4 (Toronto: Ontario Economic Council, 1976).

[2] B. Wolf, Appendix to "The Reaction of Multilateral Enterprises to Freer Trade Between Canada and the United States (York University, Toronto, November 1984, Mimeographed), pp. 5–6.

that profitable trade between countries depends on *comparative*, not *absolute*, advantage. Countries that trade with each other will export those things that they can produce comparatively cheaply and import those things that they can only produce comparatively expensively.

The mechanism that guarantees that diverse countries can trade with each other to their mutual advantage is the exchange rate. The exchange rate between any two currencies depends on the amounts of each currency that its holders want to exchange for the other currency. This, in turn, depends on the amount of foreign money that is required to affect both current account transactions — payments for goods and services — and capital account transactions — the international movement of capital funds for loan or investment. It is convenient just for this section to ignore capital movements. We do this by considering a country whose capital imports equal its capital exports so that it has neither deficit nor surplus on the capital account side of its balance of payments.

Adjustment of Cost and Price Levels

To see what is involved, consider what would happen if one country's level of money costs and money prices was, for whatever reason, so high that no foreigners wanted to buy its goods, and its own nationals rushed to buy cheaper foreign goods. In this case, no one would want to buy that country's currency on the foreign exchange market in order to spend money on its goods. As a result, the value of its currency would fall on the foreign exchange market, and, as it did, the prices of its exports would fall in foreign markets, while the prices of its imports would rise in its own domestic markets. As the exchange rate fell, the country would find that, sooner or later, the goods that it produced relatively cheaply could be sold abroad while it still paid domestic residents to buy from abroad the goods that could only be produced relatively expensively at home.[3]

The fall in the exchange rate would continue until trade was balanced: that is, until the value of the country's imports equaled the value of its exports. At this point, the demand to buy its currency on the foreign exchange market — in order to buy its exports — would equal the sup-

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[3] The argument in the text is in keeping with Ricardo's simple model where each country would typically specialize in the production of one commodity. In the case of a small open economy such as Canada, the argument proceeds a little differently but the end result is the same: the exchange rate fluctuates to ensure that each country exports enough to allow it to pay for its imports.

ply of its currency on the foreign exchange market — in order to allow its nationals to buy imports When this happened, the exchange rate would stabilize as a result of a balance between the forces of demand and supply.

Trade with Low-Wage Countries

"But surely," generations of people have asked, "this does not apply to low- and high-wage countries? Surely, if Canada trades freely with low-wage newly industrializing countries or, for that matter, with the low-wage Sun-belt states of the United States, Canada will lose out because it will be undersold in everything." The answer to this worry is that the forces just discussed apply equally to the case of trade between high- and low-wage countries. If Canada were undersold in everything, no one would want to buy the Canadian dollar on the foreign exchange market and its value would fall. This fall in the value of the dollar would go on until the value of our exports equaled the value of our imports — always assuming that we were neither a net importer nor net exporter of capital.

There is, however, an important lesson to be learned from studying the case of Canada's trading with a low-wage country. Imagine starting from an exchange rate at which Canada can sell nothing to the low-wage country. The Canadian exchange rate will fall until those goods in which Canada has a comparative advantage can be sold to the other country. But notice what these goods will be. Canada, being a high-wage, relatively high-productivity country, will have a comparative advantage in commodities that have a high value-added per unit of labor and, therefore, that can support high labor earnings. The low-wage country will have a comparative advantage in what may be called "low-wage goods", goods that have a very high labor content and that can only compete in international markets if the large numbers of workers needed to produce them receive low wages.

The important policy implication of this result is that, if the high-wage country insists on maintaining the production of its low-wage goods, it either must protect them by trade restrictions or subsidize their domestic production. In either case, the firms and workers in the protected industries will be the short-term gainers.

The firms and workers who are the losers are those who would have produced and exported high-wage goods had the low-wage goods been imported. Since trade must balance in the long term, so that the value of imports is equal to the value of exports, every reduction of imports to protect low-wage industries at home must cause a reduction in the

exports and, hence, in the home production, of goods produced by the country's high-wage industries.[4] Furthermore, if the high-wage country insists on maintaining industries that depend on low wages, then the standards of living of that country will be correspondingly lowered since the real wealth that these low-wage goods provide is necessarily low — which is why low-wage countries have a comparative advantage in producing them.

Public policy will no doubt protect the workers and owners in these industries from bearing the brunt of their low contribution to total national income — otherwise they would not continue to produce the goods in question. The burden is then transferred to the population as a whole, either by means of income subsidies to those who work in the low-wage industries or by trade restrictions that allow these industries to charge a price well above the competitive world price in their protected local market. If only a few such industries are protected, then the reduction in national living standards may be small. But the more such industries public policy does protect, the lower will be living standards, as the pattern of domestic production — and, hence, the size of total output — comes closer and closer to that of a low-wage country.

Capital Movements

So far, the discussion has ignored capital movements, and it is now time to take them into account. We shall see that they can postpone the operation of the forces we have just discussed, but, in the long term, they leave things pretty much as we showed them to be in the last section.

For example, suppose that, as a result of a trade liberalization program, Canadian imports rose by much more than its exports. In the short term, this discrepancy could be covered by foreign borrowing. But this cannot go on forever. Even if we were prepared to finance an excess of imports over exports by continuous foreign borrowing, the service charges on our past borrowing would eventually wipe out the balance

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[4] Because the low-wage goods are being made at home rather than imported, there is a smaller supply of domestic currency offered on the foreign exchange market in return for the foreign currency needed to pay for imports. This appreciates the domestic currency's value and squeezes out exports, until the value of exports equals the value of imports. When all of these adjustments have occurred, there is less domestic production — and exports — of high-wage goods in which the country has a comparative advantage, and more domestic production of low-wage goods in which the country has a comparative disadvantage.

of payments effects of the new borrowing.[5] So, sooner or later, the exchange rate would have to fall, expanding exports and reducing imports until the two came into balance.

What we have just discussed is no mere theoretician's dream. There is a large body of evidence showing that these forces really do operate in the long term. The long-term trend value of the exchange rate between one country's home currency and the currencies of the rest of the world follows the long term trend in their relative costs and prices — appropriately weighted for the volumes of trade conducted with each country. This the so-called "purchasing-power parity" theory of exchange rates, which says that the long-term trend value of exchange rates is their purchasing power rate. This is the exchange rate that equalizes in both countries' markets the average price of the goods that are traded internationally. If two countries have such an exchange rate, then they will be able to export the goods they can produce relatively cheaply and import the goods they can produce only relatively expensively.

The forces of purchasing-power parity establish the trends to exchange rates. In the shorter term, however, the exchange rate is dominated by capital movements. As a result, actual exchange rates can deviate by large amounts, and for long periods of time, from their purchasing-power parity rates.

Currently, for example, rapid growth in the U.S. economy and the existence of massive U.S. budget deficits are holding U.S. interest rates high and sucking in large amounts of foreign capital. The demand to buy U.S. dollars to invest in the United States holds the U.S. dollar high on foreign exchange markets. This puts U.S. exports in difficulty and promotes imports.

The influences on the exchange rate that emanate from the capital account can pose serious problems for a country's export industries. The relevant point for the present discussion, however, is that such problems are not confined to particular types of countries. Whether a country is rich or poor, a high- or low-productivity producer, or a high- or low-wage employer, its exchange rate will rise above the level that produces

[5] It is sometimes not appreciated just how fast this adjustment can work. Say that $1 billion is borrowed each year at an interest rate of 12 percent. In the first year, that can be used to cover a balance of payments deficit on merchandise account of $1 billion. In the second year, after paying $120 million in interest, the new borrowing of $1 billion only nets $880 million to cover a merchandise deficit. In just over eight years, interest payments are equal to $1 billion, leaving nothing from the annual borrowings to cover the merchandise deficit.

a balance of imports and exports whenever it becomes a major capital importer. The exchange rate must then rise to a level that produces an excess of imports over exports.

Quantitative Estimates of the Gains from Trade

We have seen that there are gains from trade, and that the exchange rate is the mechanism ensuring that trade liberalization does not put a country at a competitive disadvantage against low-wage or low-productivity countries. We now review briefly the studies that have estimated the gains to Canada from further trade liberalization.

Gains occur because the reduction of Canadian import restrictions contributes to more efficient allocation of production and improves consumer choice. The reduction of foreign trade barriers facilitates the expansion of exports by industries in which Canada has a present or potential comparative advantage. The magnitude of these gains depends on how much potential remains for Canadian industry to exploit economies of scale and specialization.

Unilateral Tariff Reductions

Some investigators have doubted that there would be gains from a unilateral reduction of the Canadian tariff. For example, Robin Boadway and John Treddenick, using a model that has no room for cost-reducing effects, estimate that unilateral free trade would reduce Canadian welfare.[6] One reason why it is possible to get the answer that Canada loses from unilateral tariff reduction is that many general models, including that of Boadway and Treddenick, use estimates of the foreign demand for Canadian exports that give Canada substantial monopoly power in international markets.[7] Under these circumstances, tariffs allow Canada to exploit this monopoly power, so the elimination of tariffs brings losses in terms of foregone monopoly profits. Few economists doubt, however, that in the long term, Canada is a small open economy that can do little to influence the world prices of the goods it exports. If so, there are no monopoly profits available to the Canadian economy as a whole, and the estimates that are based on their existence are erroneous.

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[6] R. Boadway and J. Treddenick, "A General Equilibrium Computation of the Effects of the Canadian Tariff Structure," *Canadian Journal of Economics* 11 (August 1978): 424–446.

[7] J. Shoven and J. Whalley, "Applied General-Equilibrium Models of Taxation and International Trade" *Journal of Economic Literature* 22 (1984): 1020.

Bilateral Tariff Reductions

Early estimates of the gains to Canada from Canadian-U.S. trade liberalization range from about 3 percent up to 10 percent of GNP.[8] The low estimates assumed no cost-reducing adjustments, while the higher estimates assumed substantial-scale economies.

Recent studies obtain similar differences in the magnitude of potential gains. Bob Hamilton and John Whalley, for example, using a model based on constant costs, estimate that gains from reducing all tariffs and nontariff barriers (NTBs) on trade between Canada and United States would amount to 1.3 percent of its GNP for Canada and 0.7 percent for the United States.[9] Although a small number, it is not altogether insignificant. Taking the real rate of return on capital in its historically observed range of between 2 and 4 percent, this gain becomes the equivalent of a once-and-for-all addition to the Canadian capital stock of from $135 to $270 billion.[10]

The Harris Study

The most recent, and the most careful, estimates of the gains from Canadian trade liberalization come from Richard Harris.[11] His estimates are by no means the last word on this issue. Rather, they should more properly be regarded as the latest in a new generation of studies, one that is no longer content with ad hoc debating points, but that attempts instead to estimate the effects of trade restrictions within the context of a carefully articulated model of the Canadian economy — a model that is based, as far as possible, on empirical observations of actual production costs and other relevant magnitudes.

Harris does not estimate directly the gains from bilateral free trade with the United States. Instead, he estimates that the annual gain to Canada from multilateral elimination of all tariff and nontariff barriers would

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[8] See J.R. Williams, *The Canadian-U.S. Tariff and Canadian Industry: A Multisectoral Analysis* (Toronto: University of Toronto Press, 1976); and R.J. Wonnacott and P. Wonnacott, *Free Trade between the United States and Canada: The Potential Economic Effects* (Cambridge, Mass.: Harvard University Press, 1967).

[9] B. Hamilton and J. Whalley, *Geographically Discriminatory Trade Arrangements*, Centre for the Study of International Economic Relations Working Paper no. 8321 (London, Ont.: University of Western Ontario, Department of Economics, November 1983).

[10] In 1984, 1.3 percent of GNP amounted to $5.4 billion, which capitalized as an annuity (v/r) at a real interest rate of 2 to 4 percent yields the estimated values.

[11] R.G. Harris, with D. Cox, *Trade, Industrial Policy, and Canadian Manufacturing* (Toronto: Ontario Economic Council, 1983), pp. 114–115.

amount to 8–10 percent of Canadian GNP. If one assumes, however, that the gains for Canada from trade with various countries are proportional to the volume of trade with those countries, then one can get an estimate of the gains from a bilateral free trade association with the United States. Since the United States accounts for about 70 percent of Canada's total trade, this suggests gains from a Canadian-U.S. free trade agreement of between 5.5 and 7 percent of Canadian GNP.

The Harris study allows for three main sources of gains from trade. First, resources are reallocated out of areas where Canadian industry has a comparative disadvantage, and into areas where it has a comparative advantage. This is the force on which Ricardo based his case for the gains from trade.

Second, free trade gives Canadian industry scope to realize those economies of scale that are currently unrealized because many Canadian markets are too small. When, under the impact of freer trade, Canadian firms specialize in fewer lines of activity and leave other lines to foreign firms, Canadian firms can have much longer production runs and much higher volumes of output. As a result, they can realize the economies of larger-scale production that are understood to be one of the most important sources of lower-cost production. In turn, producing at a lower cost means getting more output from given supplies of Canadian resources of capital and labor. This, in turn, means producing a higher GNP and, hence, higher average living standards.

Third, Harris takes into account the low level of competition in many Canadian manufacturing industries. A small number of tariff-protected firms has meant higher production costs — and higher prices to consumers — than would exist given greater competition. Generations of Canadian policymakers have tried, and failed, to institute a really effective Canadian competition policy. The Harris model suggests that Canadians can have an effective competition policy by virtue of the competition introduced through trade liberalization. This may be bad news for the now-protected owners and workers in some of the Canadian industries that will be affected, but it must be good news for Canadian consumers. For them, there is only gain as domestic prices come closer to domestic costs, and as domestic costs come closer to costs that are available in other countries to firms using the most efficient technology and selling to large markets.

Criticisms of the Harris Study

Like many seminal articles, Harris's study has been subject to sub-

stantial criticism.[12] Criticism is valuable in suggesting better studies that can be made in the future. But until one of the critics — or someone who takes their views into account — does a better study, the existing one is the best we have. Nonetheless, three criticisms of Harris's work seem important in suggesting possible major improvements that need to be made.

First, Harris assumes, without any obvious justification, a type of non-competitive behavior among Canadian firms. Free trade ends this behavior and brings gains by introducing more competition. Harris's assumption does accord with what many observers have suggested about the Canadian economy, but it is not firmly based on any well-established theory of firm behavior and, thus, at least for the present, it remains ad hoc. Because of this, there is no way to adjudicate between those who accept this description of the behavior of many Canadian manufacturing firms and those who do not.

Second, Harris's estimates of the cost-reducing effects of trade liberalization are subject to criticism. Since these are such an important contributor to the gains estimated by Harris, such criticisms are potentially serious. The debate on the measures of potential cost-reducing effects will go on for some time. At present, all we can say is that we see no persuasive reason for believing that the biases that are no doubt present in Harris's study have the net effect of making his calculations overestimate, rather than underestimate, the true gains from liberalizing Canadian trade.

The third and by far the most serious criticism of Harris's work relates to his estimates of current tariff barriers. These estimates are important since, according to Harris, the higher the current barriers, the greater the gains from removing them. To estimate current tariff barriers, Harris uses estimates of the amount of protection that existed in 1971, which was significantly higher than current levels of protection. Even more importantly, he estimates U.S. restrictions on the entry of Canadian goods into the U.S. market as being equal to those on the entry of goods from Japan and the European Community (EC). But this undoubtedly provides an overestimate of such restrictions on Canadian goods. As Whalley puts it:

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[12] This section draws on J. Whalley, "'Trade, Industrial Policy, and Canadian Manufacturing' by Richard G. Harris (with the assistance of David Cox): A Review Article," *Canadian Journal of Economics* 17 (May 1984): p. 393.

> these estimates are inappropriate for Canada, since they ignore both the substantial implicit preferences Canada already has in U.S. markets and the fact that major U.S. NTBs (such as Voluntary Export Restraints on autos) are focused most heavily on the EEC and Japan, rather than Canada.[13]

Although we are not sure that the balance of all the potential biases in Harris's estimates leads him to overestimate the gains from Canadian free trade, his are the highest of the careful estimates that have been made. So we take his as the upper bounds on these gains. The lower bounds are set by the estimates of about 1.3 percent of GNP that assume costs are unchanged by trade liberalization and that measure only the gains from reallocation of production out of industries where we have a comparative disadvantage and into industries where we have a comparative advantage.[14]

Dynamic Gains from Trade Liberalization

None of the traditional estimates of the gains from trade, including Harris's, deal with the dynamic effects of freer trade on growth and development. Debate has long raged over these matters — as it always does when careful measurements have not yet constrained the range of possible outcomes.

A reduction of trade barriers should have at least four beneficial effects on the economy:

- It would force private-sector firms to produce at world-competitive costs, rather than sheltering some existing inefficient practices behind trade barriers. This removes what economists call "X-inefficiency".
- It would promote the economy's adjustment to external competitive forces by encouraging the reallocation of labor and capital out of potentially declining industries and into potentially expanding ones. This allows the economy to become specialized in the areas of its comparative advantage. It would reduce the government's temptation to inhibit the adjustment process by shoring up firms in declining industries that are more profitably located in lower-wage countries.
- It would allow Canadian firms to introduce new products and to participate early in emerging industries because of free access to large, high-

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[13] Ibid.

[14] Hamilton and Whalley, *Geographically Discriminatory Trade Arrangements*.

income markets. Many people regard this as the most important dynamic effect of trade liberalization.

If freer trade produces more growth-initiating responses from the private sector, and fewer growth-inhibiting reactions from the public sector, then it could contribute a great deal to GNP growth, irrespective of what it does on the resource-reallocation front. Indeed, an increase in adaptability that makes even a modest contribution to the economy's growth potential could swamp any of the effects that have been estimated in the literature.

Assume, for example, that by encouraging private-sector behavior that produces more growth, and by discouraging public-sector behavior that inhibits growth, the net effect was to raise the annual growth rate by a mere one-half of 1 percent. This very modest effect would raise national income by 7 percent in 13 years. In other words, in 13 years the economy would have achieved gains equal to those that accrue because of the highest estimates of the resource reallocation and the cost-reducing effects.

These dynamic effects, however, are not necessarily all favorable. To use an analogy, if the reed is too stiff, the pressure applied may break it rather than bending it into the intended new shape. If prices, profit margins, and wage rates do not respond in a flexible way to trade liberalization, then foreign competition may reduce output and employment. The important lesson is that a policy of increased trade liberalization needs to be phased in at a rate appropriate to the economy's ability to adjust, and it needs to be accompanied by a policy that encourages, rather than discourages, the adaptation to the changes that trade liberalization inevitably requires. This "phase-in" issue is considered in detail in Chapter 9.

Trade Creation and Trade Diversion

One major effect of Canadian-U.S. trade liberalization is on resource reallocation. The theory of customs unions divides these effects into two categories:

- *Trade creation*, which occurs when, for example, Canadian firms find that they can undersell their U.S. competitors in some lines of endeavor, while U.S. firms find that they can undersell their Canadian competitors in others. As a result, specialization occurs and new international trade develops. This is trade based on natural or acquired comparative advantage.

• *Trade diversion*, which is caused by a reduction of tariffs between two countries. Canadian trade diversion occurs when Canadian firms find that they can undersell competitors from the rest of the world in the U.S. market, not because they are the cheapest source of supply, but because their tariff-free prices are lower than the tariff-burdened prices of imports from other countries. This is a gain to Canadian firms, but at a cost that is paid by the United States — which now has to export more goods for any given amount of imports than before the trade diversion occurred. Similar Canadian trade diversion occurs when U.S. producers win out over competitors from the rest of the world in the Canadian market by not being subject to a tariff in that market while their competitors are. This effect tends to benefit U.S. firms at the expense of Canadian consumers.

From the global perspective, trade diversion represents an inefficient use of resources.[15] But from the narrower national points of view of Canada and United States, it brings some gain as well as some loss. Insofar as there is a shared desire to increase domestic manufacturing production, trade diversion brings mutual benefit to both countries. It gives producers within the two countries an advantage over producers in the rest of the world, which has the effect of increasing the total amount of production and trade that occurs within the free trade area while reducing what comes in from third countries.

Summary

We have seen that there is controversy about the measurement of the gains to Canada of removing all barriers to trade between it and the United States. The lower limit is set by the gains from resource reallocation with unchanged costs, which Whalley estimates at 1.3 percent of Canadian GNP.[16] The upper limit of what can be measured includes the cost-reducing effects of trade liberalization; these numbers come out to a maximum of 7 percent of GNP. When we look at individual case studies where liberalization has already occurred, it seems to us that, although the overall measurement is still subject to substantial uncertainties, cost

[15] The theoretical literature suggests that we should consider a further possibility. Trade diversion may divert demand onto a product that is subject to scale economies. In this case, trade diversion may be efficient from the world's point of view. Although at the outset trade is diverted to higher-cost sources, once production is expanded and cost economies are realized production costs may be lower than they were originally.

[16] Hamilton and Whalley, *Geographically Discriminatory Trade Arrangements*.

reductions due to rationalization of product lines and increased length of runs are important. It should also be noted that these measurements only set limits to the effects of those influences that can currently be measured. We observed in the previous section that there were potentially large, dynamic effects that no one has yet attempted to measure.

Canadian Trade Policy in a Nutshell

So much for a general discussion of the effects of trade liberalization. In the remainder of this chapter, we briefly outline Canada's past and present trade policy. This is a prelude for considering in the next chapter Canada's options for future trade policy.

Early Trade Policy

The United Kingdom set early trade policy for the Canadian colonies, and it provided substantial tariff protection. Then, in 1846, it unilaterally adopted free trade. Alarmed by the loss of Imperial Preferences, the Canadian colonies entered into the Reciprocity Treaty with the United States in 1854. This allowed free trade in a wide range of primary products. The treaty was for a term of ten years, with a one-year notification requirement for termination.[17] As John Young observes:

> Particular bitterness was aroused in the United States by the Canadian tariff increases of 1858 and 1859. Since these involved manufactured goods, they were within the letter of the treaty, but it was argued that they were contrary to the spirit of the arrangement. Partly because of these increases, but mainly as a result of ill-feeling generated during the Civil War, the United States government abrogated the treaty at the first available opportunity, and the treaty ceased to be effective as of March, 1866.[18]

Attempts were made to get a new treaty, but when the U.S. Senate failed to ratify the draft treaty of 1874, these attempts languished.

Trade Policy Turns Inward

A few years later, in 1879, Canadian policy took an abrupt about-turn with the National Policy of Sir John A. Macdonald. This policy made Canada's industrial development depend on import substitution: it raised

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[17] J.H. Young, *Canadian Commercial Policy*, Study prepared for the Royal Commission on Canada's Economic Prospects (Ottawa: Queen's Printer, 1957), p. 30.
[18] Ibid.

tariffs in order to protect the Canadian market for Canadian-based producers. This encouraged foreign firms — particularly those in the United States — to establish branch plants and subsidiaries in Canada to serve the local market, thus replacing imports with locally produced goods.

This may well have been the right route to development for the small and fragile Canadian economy, located as it was next to a U.S. colossus flexing its newly developed industrial muscle — although this has been the subject of heated debate among Canadian economic historians.

In 1911, the two countries negotiated an agreement for a substantial bilateral reduction of tariffs, but before the agreement could receive legislative ratification in either country, a Canadian election intervened. The resounding defeat of the Liberal government of the day was taken as an expression of public opinion against freer trade with the United States.

In 1948, a Canadian-U.S. free trade agreement was discussed at some length, but the discussions ended when the then-Canadian Prime Minister, W.L. Mackenzie King, expressed his disapproval.

Until World War II, the United Kingdom was Canada's most important trading partner. In 1938, for example, 40 percent of Canada's exports went to that country while only 23 percent went to the United States. After the war, the United Kingdom's importance as a market for Canadian exports declined steadily, and finally fell to very low levels after that country entered the EC. In 1984, only 2.2 percent of Canadian exports went to the United Kingdom as contrasted with 76 percent to the United States (see Table 4).

Trade Policy Turns Outward

The decisive switch in Canadian trade policy perspective came when Canada became a signatory to the General Agreement on Tariffs and Trade (GATT) in 1947. This committed Canada to an outward-looking policy of multilateral trade liberalization — although at the time no one knew how much trade liberalization the GATT would actually accomplish. From 1947 to 1960, several rounds of negotiations accomplished small reductions in tariffs. Then, in 1963, came the Kennedy Round, at which really substantial tariff cuts were agreed upon. These were phased in over the 1966–72 period. As a result, Canadian industry faced, and accomplished, a major adjustment to trade liberalization.

The next, and most recent, set of negotiations was the Tokyo Round. Once again, really substantial tariff cuts were agreed upon. These tariff cuts are now being phased in according to a timetable that is to be com-

pleted by January 1987. By then, more than 95 percent of Canadian imports from the United States will be traded either duty free or at tariff levels of less than 5 percent. Comparatively speaking, Canada has made deeper tariff cuts than have most other nations. Nonetheless, final Canadian post-Tokyo Round tariff levels will remain somewhat higher than those of most other industrial countries. The Tokyo Round directed a great deal of attention to NTBs, and the agreements reached there attempted to clarify and standardize the legitimate use of such measures in the hope that this would limit their use as nontariff barriers to trade.

TABLE 4
Distribution of Canadian Exports by Trading Areas, 1960–84
(percentage)

	1960	1970	1980	1983	1984
United States	55.8	64.4	63.2	72.9	75.6
United Kingdom	17.4	9.0	4.3	2.8	2.2
Other Western Europe	11.3	9.8	10.6	5.8	5.0
Japan	3.4	4.9	5.9	5.3	5.1
Other Asia	2.2	2.9	4.0	4.4	3.8
Other	9.9	9.0	12.0	8.8	8.3
Total	*100.0*	*100.0*	*100.0*	*100.0*	*100.0*

Sources: Statistics Canada, *Exports: Merchandise Trade*, Cat. no. 65-202, various issues; idem, *Summary of External Trade*. Cat. no. 65-001, various issues; and idem, *Trade of Canada, Summary and Analytical Tables*, Cat. no. 65-201, 1959-60.

Present Policy

Taking the end of 1984 as our benchmark, Canadian commercial policy in the post-Tokyo Round era can be summarized under five main headings:

• *Tariffs*. Since entering the GATT, Canadian policy has been turning away from the old inward-looking National Policy instituted by Sir John A. Macdonald, and toward a policy of multilateral trade liberalization. By its own historical standards, Canada is now a low-tariff country, although by the standards of other industrial countries, Canada is still on the high-tariff side.

• *Contingent protection.* The *Special Import Measures Act* passed by Parliament in 1984 brings our NTB practices much closer to those of the United States, and introduces several measures that could easily increase Canadian protectionism. For example, the act broadens the terms and applicability of countervail; it broadens the types of adverse effects from imports that may be considered legitimate reasons for the application of countervail and antidumping duties; it makes safeguard measures, which are protectionism without the excuse of foreign subsidies or dumping, easier to apply; and, finally, it gives a broader role to "undertakings" — a role that may considerably reduce the transparency of Canada's trade policy and result in a covert drift towards managed trade and protectionism.[19] ("Undertakings" are agreements between the Canadian government and foreign firms, or governments, covering such matters as allowable amounts of imports, subsidies, and the prices of imports that will not make them subject to antidumping proceedings.)

• *Sectoral trade restraints.* Such arrangements have been applied in the footwear, automobile, and textile and apparel sectors. They include such measures as import quotas and voluntary export restraints, which are agreements reached with the source country to limit its exports to Canada.

• *Sectoral free trade initiatives.* Decisions taken at the beginning of 1984 led to the establishment of joint Canadian-U.S. working groups to study the feasibility of initiating negotiations on sectoral free trade covering four sectors: steel, agricultural equipment, informatics, and government procurement. By the end of the year, preliminary discussions had ended and the two governments were each studying these, and other options, for Canadian-U.S. bilateral trade liberalization.

• *Policies that affect trade only incidentally.* Many policies that have their prime objectives in other fields nonetheless have significant influences on trade. The National Energy Program, introduced in 1980, had many provisions that were perceived as protectionist. For example, the Petroleum Incentives Program makes exploration and development incentives dependent on the degree of Canadian ownership of the firm. Furthermore, operation "guidelines" placed on firms many local procurement pressures. The Foreign Investment Review Agency (FIRA), formed in 1973, was also accused of operating as a protectionist mechanism. FIRA frequently violated the principle of "national treatment" by subjecting foreign-owned firms to local procurement and export require-

[19] See K. Stegemann, *Report of the Policy Forum on Special Import Measures Legislation*, Policy Forum Series no. 4 (Kingston, Ont.: Queen's University, John Deutsch Institute for the Study of Economic Policy, 1984).

ments, resale restrictions, and other limitations not imposed on Canadian-owned firms.

Policies relating to communications and the media have often had protectionist implications. The tax treatment of advertising expenditures by Canadian firms in the U.S. broadcasting and print media, copyright issues relating to Canadian cable television retransmission, and discriminatory postal rates for magazines are the main cases in point here.

Government regulation of various industries often has protectionist side effects. As an example, Canadian authorities have denied foreign airlines fare and route changes that have been permitted for Canadian carriers. Trucking regulations have often been criticized for protectionist elements.

In summary, developments in Canadian trade policy are not unlike those to be found in many other countries. There has been a major movement to lower tariffs on a multilateral basis, a movement that is still in progress. There has also been a secondary, but accelerating, movement to resort to increased use of contingent protection mechanisms. The experience of history is that any temporary advantage one country gains from the unilateral imposition of some trade barrier is soon lost when other countries retaliate. There are several Canadian examples. Two of the latest are the recent passage of U.S. mirror legislation that does to Canadian border broadcasters what Canadian legislation did to U.S. border broadcasters in the 1970s; and the recent EC threat to raise tariffs on chemical and steel products, fur coats, kraft paper, and car radios in retaliation for Canadian quotas on footwear.[20] Also, as this last example shows, the effect of such measures is often to support our high-cost, low-income-producing industries at the expense of those industries in which we have a comparative advantage. Canadians, whose long-term economic well-being is linked to the multilateral trading system, need to be wary of the worldwide rise in protectionism, and of any encouragement Canada gives to such trends.

Outline of the Study

The long-term economic prospects of both Canada and the United States have been affected by major changes in the world trading environment. Some of these are irreversible; others may persist for a long time. The

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[20] See D. Stewart-Patterson, "EC Shoe Deal Fits, but Beef Issue Is Still Tough," *Globe and Mail* (Toronto), March 30, 1985, p. B3.

interests of both countries would be served not only by liberalization of trading arrangements on a global basis but also between the two countries.

Because of its diminished economic prospects and its small market size, it is Canada which must initiate negotiations for freer trade. Debate in Canada ranges over a number of options. These include maintaining the status quo, retreating into an inward-looking protectionist stance, or opening up to more liberal external arrangements. Chapter 4 examines these options, and concludes that the outward-looking options are the only way for Canada to go. Chapter 5 then gives a detailed consideration of the option of bilateral trade liberalization between Canada and the United States. After considering the alternatives within this option, including the type of piecemeal negotiations on specific issues that Ottawa now seems to be seriously considering, we conclude that the best chance for real success lies in negotiating what Article XXIV of the GATT calls a "free trade area".

In choosing among the options, Canadians face some serious concerns over both economic and noneconomic issues. Chapter 6 examines major political and cultural questions that bother Canadians, while Chapter 7 examines the economic concerns related to the adjustments to, and possible long-term consequences of, changing Canada's trade arrangements with the United States. If these concerns can be met, a number of features of any trade liberalization agreement would have to be debated and negotiated. These are the issues explored in Chapters 8 and 9. Chapter 10 then provides an overall summary of the issues and an assessment of Canada's trade policy options.

PART II

Canada's Trade Options

4

The Options

The major choice regarding Canadian trade policy has always been between inward- and outward-looking options. The former seek to base much of Canada's growth on Canadian-based firms serving a protected Canadian market. The latter seek to do so with Canadian-based firms having a strong export performance.

Policy Background

In Chapter 3, we mentioned the two major historical changes in the Canadian trade policy stance. The first was an abrupt switch from an outward-looking to an inward-looking approach when Sir John A. Macdonald instituted the National Policy in 1879. The second was a gradual evolution towards an outward-looking policy that began when Canada became a signatory to the General Agreement on Tariffs and Trade (GATT) in 1947.

Over the years following World War II, long-term changes in world trading relations have led inevitably to increased Canadian dependence on the United States, both as a market for exports and as a source of capital. In the 1970s, the so-called "Third Option" was designed to reduce this dependence by switching some of our trade to Europe and to developing countries. Hostility to foreign capital led to the creation of the Foreign Investment Review Agency (FIRA) in 1972 and culminated in the National Energy Program (NEP) in 1980.

As Canada's economic position worsened in the 1980s, fear of too much foreign capital gave way to fear of too little. FIRA became Investment Canada, but with many of its restrictive provisions left in place. The search also began for new trade initiatives. The Senate Committee on Foreign Affairs surveyed the issues and recommended a free trade association with the United States.[1] The Department of External Affairs

[1] Canada, Parliament, Senate, Standing Committee on Foreign Affairs, *Canada-United States Relations*, 3 vols. (Ottawa: Queen's Printer; Supply and Services Canada, 1975–82).

published two documents in the 1980s. The first was rather cool to the idea of a free trade association and looked to other, less drastic methods of encouraging trade.[2] The second was skeptical of the then-current initiatives for free trade agreements in particular sectors, and was more optimistic about the possibility of across-the-board measures to liberalize trade with the United States.[3]

Current Choices

Most Canadians realize that these issues of trade and investment policy are crucial to our economic prosperity over the rest of the century. For them, the current debate centers on the pros and cons of the options that are now available. In this chapter, we describe and evaluate the five main options:

- *Option one:* continuing with the status quo of a gradual movement towards trade liberalization through existing channels.
- *Option two:* reversing our present policies by turning Canada inward in the direction of the National Policy of Sir John A. Macdonald.
- *Option three:* resurrecting the so-called "Third Option" of encouraging trade with Europe and the developing countries.
- *Option four:* pursuing a much more aggressive policy of multilateral trade liberalization.
- *Option five:* moving toward some form of comprehensive, bilateral trade liberalization with the United States.

Option One: The Status Quo

We use the term "status-quo option" to mean continuing with our current policies. Another way to describe this option would thus be: "steady as she goes".

Description

The main characteristics of the status-quo option are fairly clear:

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[2] See Canada, Department of External Affairs, *Canadian Trade Policy for the 1980s: A Discussion Paper* (Ottawa: Supply and Services Canada, 1983); and the accompanying paper, *A Review of Canadian Trade Policy: A Background Document to Canadian Trade Policy for the 1980s* (Ottawa: Supply and Services Canada, 1983).

[3] The second is the Hon. J.F. Kelleher, *How to Secure and Enhance Access to Export Markets* (Ottawa: Government of Canada, January 1985).

- It would rely on the GATT for further trade liberalization.
- It would involve continuing to protect certain high-cost Canadian industries from foreign competition.
- It might involve continuing to try to deflect some of our trade with the United States toward other countries, although measures with serious results seem quite unlikely.
- It would probably involve some continuing ambivalence toward U.S. investment in Canada, although in a much less serious way than in the decade that included FIRA and the NEP. In other words, the status quo option would leave Investment Canada in place and with its existing powers, which are still quite restrictive, intact.
- It would mean *not* making major changes in the pattern of economic incentives designed both to increase the inflows of foreign capital into Canada and to reduce the outflows of Canadian capital to the United States. Changes in these incentives can be achieved, as we shall see, as a by-product of option five.

Assessment

We see five very serious problems with the status-quo option. The first is that it would leave our hopes of further trade liberalization resting solely on the success of the next round of GATT negotiations, which will probably begin in the late 1980s. No one can foretell the outcome of these negotiations, but many people believe that much of the momentum for reductions in trade barriers has gone out of the GATT. As Jan Tumlir, a senior GATT official, states:

> There are coalitions supporting liberal trade, but they are precarious at the best of times and, in fact, they are weakening at present. In the United States, the traditional lynch-pin of the liberal trade coalition was the farm block, which is now alienated and learning to take care of its interests through inter-governmental market-sharing arrangements. The effort to replace it by a constituency consisting of service industries doing international business, the multinational enterprises and the smaller domestic firms producing high-technology goods failed at the ministerial meeting of the signatory countries to the General Agreement on Tariffs and Trade...in November 1982. The European Community wants the rest of the world to go away. Japan needs a multilateral trading system so badly that she is willing to renounce its benefits to the country one by one, such successive renunciation being motivated by the hope that it will help to preserve the rest.[4]

[4] J. Tumlir, "Need for an Open Multilateral Trading System," *The World Economy* 6 (1983): 393–394.

Many people see a rise in nontariff barriers (NTBs) as the most potent force operating to change trade policies today, and they feel that GATT is the world's best defense against a rise in trade barriers. This is an important function, but in itself it does not hold out great hope for a policy of further trade liberalization. The next round of GATT negotiations will be preoccupied with NTBs, and it is possible that the negotiations will make more progress in reducing them than the pessimists expect. But, while many of the world's economies remain in their present depressed condition, and while the high U.S. dollar continues to squeeze U.S. import-competing industries, political pressures are likely to push for more, rather than less, protectionism. In such an environment, relying on the GATT as the only instrument for further major trade liberalization seems risky. This policy option thus risks leaving our level of trade liberalization about where it is today.

The second problem with the status quo is that it would continue to leave Canadian industry without secure and unimpeded access to a large market. The inward-looking approach of option two would attempt to remedy this situation by raising Canadian trade barriers with the intention of creating a secure local market. The outward-looking options would attempt to remedy the situation by gaining secure access to large foreign markets. Advocates of both options agree that the present situation is unsatisfactory. It leaves many Canadian firms not only unable to reach world-competitive costs but also vulnerable to new trade-restricting measures adopted by our trading partners.

The third main problem with the status quo is that it would give us too little insulation from the rising tide of protectionist sentiment in the U.S. Congress. U.S. protectionism is a threat to all trading nations. Given the extremely exposed position of Canadian exporters, relying as they do on the U.S. market for four-fifths of their sales, it seems almost irresponsible to pass up any serious chance that is open to Canada for reducing this threat.

The fourth problem with the status quo is that it would do little to force the economy's adaptation to increasing competition from the newly industrializing countries (NICs). Given the continued economic development of the NICs, Canadian import-competing industries that are "down market" are likely to remain under severe competitive pressure. Without the expanding "up-market" opportunities that would be caused by trade liberalization, the government would be pressured to give additional protection to "down-market" industries competing with a host of NTBs. So the status quo policy would prevent the achievement of one important

objective for the year 2000: by then, Canada should have vacated the production of low-income-producing products and have shifted into the production of goods and services that will sustain high incomes.

The fifth problem is that the status quo would leave in place the incentives that successful Canadian firms now have to make direct investments in the United States in order to avoid actual, and anticipated, U.S. NTBs. As long as our industrial development was based on the home market, tariffs were to our advantage because they forced foreign firms to locate in Canada to serve the Canadian market. Now that so many Canadian firms are able to export, the tables have been turned. A Canadian firm exporting to the United States has an incentive to locate its production there in order to avoid U.S. tariffs and NTBs. This is a worrying situation, and the longer it is ignored, the more serious it becomes. Once Canadian-owned plants locate in the United States, they will tend to stay there. The status quo option can do little to address this serious problem.

Option Two: The Inward-Looking Policy

This policy is inward looking because it would return Canada to its earlier policies of basing industrial development on industries supplying a protected home market. It could also be called "nationalist" because some of its strongest advocates have been the so-called "Canadian economic nationalists". Whereas Canadian internationalists tend to look to foreign competition to provide the forces needed to induce revitalization and adaptation of Canadian industry, the nationalists seek to "build from within", which means revitalizing Canadian industry through internal forces and only then asking it to stand up to foreign competition.

Description

One of the fullest expositions of the inward-looking option is to be found in Abraham Rotstein's book, *Rebuilding from Within*.[5] His theme is that Canada should abandon its old, three-pronged policy of trade liberalization, a passive industrial policy, and quiet diplomacy in Washington. Canada should pursue instead a full-scale industrial policy to which trade policy would be subordinated.[6] This new policy should be designed

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[5] A. Rotstein, *Rebuilding from Within: Remedies for Canada's Ailing Economy* (Ottawa: Canadian Institute for Economic Policy, 1984).

[6] Ibid., p. 37.

to address three main issues: research and development, import substitution, and the behavior of multinationals. Industrial policy would seek to make Canadian firms more efficient by stressing local R&D; trade policy would provide these firms with a secure local market by allowing import substitution behind increased barriers to imports; and multinational firms would be forced to behave in a socially desirable way by granting them entrance to Canada only on the basis of commitments to production levels, R&D expenditures, and employment requirements. Later, after Canadian industry had been rebuilt from within, trade barriers would be reduced and some of the gains from trade achieved.[7]

Assessment

The alleged advantages of this option are that it would attack the problems of Canadian competitiveness and the need for secure access to a suitable market. The overwhelming disadvantage seems to us to be that it would chart an extremely risky course for Canada.

Industrial Policy

The option's centerpiece is an active, and interventionist, industrial policy. The details of these proposals are still evolving, but the general approach is to rely on the government to do several things: to encourage more R&D than the market would normally provide; to pick winners, if not in the sense of specific firms, at least in the sense of specific products and industries; and to back these potential winners with more funds than the market would provide.[8]

Policies to encourage such activities as R&D can sometimes go disastrously wrong, as did the Scientific Research Tax Credits introduced in the former Liberal government's last budget.[9] Specific worries aside, however, the general tenor of the inward-looking industrial policy is to prefer bureaucratic, rather than market, decisionmaking in the key activities of R&D and innovation. In doing so, the option risks repeating many of the interventionist policies followed, without notable success, by the U.K. government in the 1960s and 1970s.

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[7] For these and other details, see Ibid., Chapter 3.

[8] See B. Wilkinson, *Canada in the Changing World Economy* (Montreal: C.D. Howe Institute, 1980), pp. 128–129; and Rotstein, *Rebuilding from Within*, especially pp. 50–55.

[9] See "Ban on Quick Flips Changes Research Credit Scheme," *Financial Post*, October 20, 1984, p. 21.

Increased Protectionism

The second prong of the inward-looking option is to provide secure access to the Canadian market for Canadian-based firms.[10] Behind increased protectionism, Canadian industry is meant to respond to this policy by becoming more dynamic and cost competitive. But the evidence suggests that trade restrictions often have the effect of reducing, rather than increasing, competitiveness.

Consider, first, the effect on costs. The protected market offers higher earnings than would the same market if it were open to foreign competition. A common response of firms is to raise the level of costs and profits as management and labor share in the monopoly profits that the trade restrictions create. Another response, and one that has already been observed in Canada, is for firms to sell a full range of products — for example, every grade and size of paper — so that costs remain above those achieved in other countries because of the small production runs that result. Both of these forces push costs higher.

Second, another common response to tariff-protected markets is for firms to spend less on R&D and to take fewer risks of innovation because they feel less need to keep ahead of potential foreign competitors. In such cases, the response of firms to tariff-protected earnings has been to become less, rather than more, dynamic.

The Do-or-Die Nature of the Industrial Policy

It follows that to get a *net* lowering of costs, the cost-reducing effects of the industrial policy must exceed the cost-increasing effects of the increased barriers to trade. So, as far as the objective of reducing costs is concerned, the industrial policy would have to run hard just to stay where it is.

We have already observed that the supporters of trade-liberalization options advocate many different stands on industrial policy. When trade liberalization is made the centerpiece of a policy package, industrial policy is complementary to it, since both policies are intended to have the same effect of encouraging cost reductions and increasing competitiveness. But with the inward-looking option, a tough industrial policy is essential. The whole option fails if the industrial policy fails. This is because, as we have seen, the trade-restriction policy would tend to increase Canadian costs. This puts all the responsibility for reducing costs on the in-

[10] Rotstein, *Rebuilding from Within*, pp. 50–51.

dustrial policy. Of course, no one can tell in advance how much success this policy would have. The experience of other countries, and of previous Canadian governmental attempts to improve on the efficiency of market decisions, leaves us feeling that it would be highly risky to rely on such an industrial policy as the main vehicle for increasing Canadian cost competitiveness.

International Effects

Although serious, the problems so far considered are small compared with the international effects of the inward-looking option, which its authors have failed to take into account. Two of the most important of such effects concern the reactions of the U.S. government and of successful Canadian exporters.

Consider the U.S. reaction first. The initial stage of the inward-looking plan calls for increased barriers to trade with the United States.[11] This action invites serious U.S. retaliation. Given the current protectionist sentiments in the U.S. Congress, few will doubt that this invitation would be accepted. If retaliation occurs, then our sheltering of the Canadian market will have made it more difficult for Canadian firms to export to the United States.

The second stage of the nationalist plan then calls for a liberalization of trade *after* Canadian firms have achieved costs that are competitive.[12] At this point, presumably, Canadian trade restrictions would be relaxed, and we must assume — although nothing about this is mentioned in Rotstein's book — that the United States is expected passively to follow suit by reducing its barriers to Canadian trade. Given the way the U.S. Congress works, and given the hostility that the first phase of increasing Canadian trade restrictions will have aroused in the U.S. administration, it seems hard to take this possibility seriously. So one risk of the inward-looking option is that it would cause a significant increase in U.S. barriers to Canadian exports, and that these barriers would be hard to reduce subsequently just because Canadians then wished them to be reduced.

An even more serious issue is that many, perhaps most, of the specific policies needed to implement the inward-looking option are *countervailable*. Subsidies and other measures of an interventionist industrial policy risk serious countervail. Such actions would reduce Canada to a siege economy, with shrinking foreign trade, and with more and more firms trying to stay in business on the basis of the small Canadian market.

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[11] Ibid., pp. 21, 50–51.

[12] Wilkinson, *Canada in the Changing World Economy*, p. 126.

The second international issue that seems to have been ignored by the framers of the inward-looking option is the reaction of Canadan exporters to the first phase of the policy. Canadian firms that are currently able to sell in the United States would be given an increased incentive to move their productive facilities there as both countries raised their trade restrictions. Furthermore, the industrial policy, even if it is successful, would not succeed all at once. Instead, one firm or industry after another would find that it is able to compete abroad. But trade restrictions, which are a key part of the option, would still be in place. So the emerging, successful firms would continue to get the same signal: locate your plants abroad in order to have secure access to the U.S. market. At the end of the process, most potential exporters would have left the country, and the remaining firms would have become, on average, less and less able to compete, and so more and more dependent on trade restrictions whose increasing severity they would continue to urge on the government.

The Implications of Failure

The irony of this "failure case" is that it would end up destroying many of the things that Canadian nationalists — as well as Canadian internationalists — seek most to protect. Nationalists worry a great deal about Canadian cultural and political integrity. Instead of protecting this integrity, the policy of "building from within" would seriously threaten it, if the policy fails. One way to jeopardize our present cultural-support policies is to have a GNP that is shrinking relatively to other countries. In this case, such policies would seem to be expensive, and dispensable, luxuries. One way to jeopardize our political independence is to have our living standards fall so far below those in the United States that many of the most productive Canadians emigrate, and some provincial governments begin to wonder aloud about what they perceive to be the excessive economic cost of maintaining an independent Canada.

No one can prophesy the outcome of these forces. But one can imagine what would happen if the differential of U.S. over Canadian living standards rose from its present level of 10–20 percent — depending on how it is measured — to 50 percent, or even 100 percent, which is the sort of thing that happened between Germany and the United Kingdom, and between Canada and Argentina, in less than three decades.[13] There seems

[13] From 1950 to 1982, real GNP per capita in West Germany rose by 467 percent while only increasing 212 percent in the United Kingdom. Similarly, from 1925 to 1984, real GNP per capita in Canada grew 265 percent while only growing 65 percent in Argentina (see footnote 3 to Chapter 2).

little doubt that in this event, the political and social pressures on the Canadian union would increase enormously.

Although this "failure case" is not the only possible outcome of the inward-looking option, it seems the most likely one to us. In any event, it is, at the very least, a significant risk. Indeed, the inward-looking option seems so risky that we can only wonder if its authors have thought out its full international implications. Since the option seems to entail risks that are so large as to be not worth taking, we reject it.

Options Three, Four, and Five: Trade Liberalization

The alternatives to the inward-looking option two are the outward-looking options three, four, and five, involving trade liberalization. Those advocating these options differ in the strategies they would adopt, but they agree on the basic end. For the moment, we look at the common core of the outward-looking position; later we discuss the differences.

The Case for Looking Outward

The case for the outward-looking options is in two parts:

• *The positive advantages of an outward-looking initiative.* The first part of the case stresses two major reasons for the importance of foreign trade to Canada.

First, a high level of foreign trade is essential to maintain high Canadian living standards. The reasons were detailed in Chapters 2 and 3. To enhance foreign trade, advocates of these options wish to see a reduction of barriers on trade between Canada and the rest of the world, by which is meant every foreign country if possible.

Second, freer foreign trade is one way of maximizing the amount of competition in the Canadian economy. Advocates of options four and five — but not three — stress competition as one of the major forces leading to progress in Canadian industry. They believe that protection, resulting from either tariffs or NTBs, tends to shelter firms — making them less dynamic and open to change — and to keep costs up as labor gains its share of the monopoly profits that are created by protectionism. They hold, therefore, that trade liberalization is the route to a more dynamic, adaptable, and lower-cost economy. Since lower costs mean that more can be produced with a given supply of national resources, lower costs also allow for increasing living standards.

So, advocates of the outward-looking options accept increased for-

eign competition and increased access to large foreign markets, as major goals of Canadian trade policy. They see these as an important part of the package designed to raise Canadian living standards and to get Canada where we would like it to be in the year 2000.

• *The defensive advantages of an outward-looking initiative.* The other part of the outward-looking case is defensive. The argument is in three steps: first, Canada depends on trade with the United States for much of its well-being; second, current worldwide protectionist sentiments seriously threaten to restrict Canadian exports; and third, therefore, a major, outward-looking initiative is of critical importance to protecting the future growth of Canadian prosperity.

All supporters of the outward-looking options have this much in common. Where they differ is on the stress they place on bilateralism and multilateralism. The third option stresses an interventionist form of bilateralism; option four stresses multilateralism; while option five suggests that multilateralism be pushed as much as possible, but assumes that it would not yield sufficient results in today's world, and so stresses a market-oriented bilateral approach specifically involving the United States.

So much for the outward-looking options in general. Let us now look at each of these options in turn.

Option Three: The "Third Option"

Description

This option consists of variations on the Trudeau government's "Third Option" of the 1970s.[14] It seeks to reduce Canada's trade dependence on the United States by increasing our trade with Europe and the developing countries. Since normal commercial relations are unlikely to accomplish such a shift, proponents of this option look to state trading agreements and directed trade on the part of governments themselves or their Crown corporations and state trading companies.

Since the increased trade would be accomplished by a series of bilateral agreements with various countries, the option can be characterized as "multiple bilateralism". Although the Third Option of the 1970s stressed closer economic ties with Europe, today such arrangements would likely be directed at areas outside of the industrial countries.

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[14] M. Sharp, "Canada-U.S. Relations: Options for the Future," *International Perspectives* (Special Issue, Autumn 1972), p. 15.

Some of those who would not go as far as the Third Option still look for a more aggressive pursuit of trade with countries other than the United States. Advocates of this view believe that Canadian producers and officials have not been nearly as aggressive at pursuing export promotion as have the officials of other countries. This option, therefore, calls for major changes in the behavior of Canadian exporters and the bureaucracy so that they become modeled after, say, the Japanese.

Assessment

There are several reasons for rejecting this option as Canada's major trade policy in the 1980s. First, Canada's effort to promote trade, investment, and technological links with the European Community in the 1970s failed completely to achieve its objective of reduced trade dependence on the United States. Since the early 1970s, exports to Europe have contracted from almost 20 percent of the total to about 8 percent in 1984 (see Table 4).

Second, the markets of the developing countries are relatively unimportant to Canada today. While we should be poised to take advantage of opportunities for expanding trade with these countries, we cannot rely on them as our main source of trade expansion over the next decade. They now account for 7.4 percent of our exports.

Third, the expansion of trade in these areas would rely on agreements between governments, Crown corporations, and state trading companies that would take decisions differing from those which the free market would generate. Enthusiasm for such state trading efforts has waned after the dubious success of such ventures as the sale of the Candu reactor to Argentina or Petro-Canada's oil contract with Mexico.[15] It is doubtful that such initiatives would appeal to many today, when a decreased, rather than an increased, state role in market decisions is being emphasized.

Fourth, the policy of promoting exports through concessional government financing is for Canada a costly option. Canada lacks the fiscal capacity to compete with the treasuries of such countries as Japan, the United States, or France.

Option Four: The Aggressive Pursuit of Multilateralism

This option appeals to many who see trade liberalization as important

[15] See M. Gordon, *Government in Business* (Montreal: C.D. Howe Institute, 1981), pp. 94–94, 187–189.

to Canada but who are wary of option five.

Description

This outward-looking option calls for Canada to pursue as aggressively as possible all the available options for multilateral trade liberalization. This would include Canadian support for another round of GATT negotiations, but could go beyond this by seeking agreements among small groups of industrial countries to control the use of particular NTBs or to liberalize trade in services. This latter approach is sometimes referred to as "conditional most-favored nation" (MFN) treatment. The essential concept is that only countries that accept obligations under a particular agreement enjoy the benefits of its provisions, but participation is open to any country that is prepared to meet the conditions laid out in the agreement. An example of this approach is the Royal Bank of Canada's proposal that Canada and the United States negotiate freer trade in computer services and invite other countries to participate.[16]

Assessment

Positive Advantages of Increased Multilateralism

Advocates of this option hope to achieve increased trade liberalization through multilateral means. Clearly, the main tool is the GATT. The possibilities of doing this have already been discussed. The main issue is *how much more* trade liberalization can be accomplished through the GATT and *how fast*. Supporters of this option tend to answer, "quite a lot," and, "quite soon." Skeptics tend to answer, "not enough," and, "not soon enough" — at least not soon enough to solve the problems currently facing Canadian industry in general, and Canadian exporters in particular.

When we consider the positive issue of encouraging more trade liberalization, we see that the advocates of option four tend to take a less urgent view of current Canadian problems, and a more hopeful view of what multilateralism will accomplish, than do advocates of option five. They believe, therefore, that existing multilateral initiatives will be suffi-

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[16] R. Frazee, *Trade and Technology: It's Canada's Move* (Montreal: Royal Bank of Canada, 1983); and R. de C. Grey, *Traded Computer Services: An Analysis of a Proposal for Canada/U.S.A. Agreement* (Montreal: Royal Bank of Canada, 1983).

cient. Skeptics tend to take a more urgent view of Canadian problems, and a more pessimistic view of what multilateralism can accomplish. This leads them to the conclusion that these multilateral initiatives will be insufficient by themselves.

The proposal for agreements that involve only the industrial countries could be more feasible than agreements involving developing countries, particularly on issues like services. The European Community, however, has become a significant stumbling block to this type of trade initiative as well.[17]

Alleged Defensive Advantages of Avoiding Canadian-U.S. Bilateralism

The negative side of the multilateralist case lies in a fear of the outcome of bilateral initiatives with the United States. Two points are made in this connection.

First, many who support options three and four tend to take a pessimistic view on the issues which we discuss later. For example, they are skeptical about the chances of reducing U.S. NTBs, and they worry that Canada may be forced to fall in line with U.S. tax and subsidy policies. These views will be discussed in Chapters 7 and 8 when the issues arise. In the meantime, we merely observe that the advocates of option four are willing to put all of their eggs into the multilateral basket, both because they believe that there is still much potential for gain in the multilateral approach and because they fear that there is much potential for loss in the bilateral approach.

Second, many who support options three or four fear that in bilateral Canadian-U.S. bargaining, Canada will tend to lose more than it gains, while in GATT bargaining, Canada will come out better because it is protected by the large number of participants. This case has three major weaknesses, which we need to consider now.

Is Multilateral Bargaining Superior to Bilateral Bargaining?

Three points need to be made. First, such evidence as there is does not support the view that the Canadian mouse always loses in disputes with the U.S. elephant. David Leyton-Brown, for example, has studied

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[17] G. Patterson, "The European Community as a Threat to the System," in W.R. Cline, ed., *Trade Policy in the 1980s* (Washington, D.C.: Institute for International Economics, 1983), pp. 223–242.

all of the cases of Canadian-U.S. conflict in commercial policy.[18] He concludes that the outcomes are almost equally divided between the two countries' perceived interests. Even more interestingly, the Canadian government won more than it lost in those cases where it chose to politicize, and therefore polarize, the issue in question. Whatever else they may tell us, these results do not support the popular view that Canada almost always loses in such disputes or that, when things get openly aggressive, Canada is almost sure to lose. Of course, disputes on commercial policy are not treaty negotiations. But the fact that the popular image can be so far wrong on this related issue suggests that it is not obvious that Canada must come out the loser in bilateral treaty negotiations.

Second, Canadian interests sometimes take a backseat in multilateral negotiations. All too understandably but equally regrettably from the Canadian point of view, large countries often negotiate GATT agreements that are mainly dictated by their own mutual interests, and that are then automatically extended to smaller countries such as Canada. As one example, procurement was up for negotiation in the Tokyo Round of the GATT. But Japan and Europe were unwilling, for their own reasons, to include public utilities in the negotiations. As a result, urban transit equipment, which was of considerable concern to Canada and which the United States had expressed willingness to include, was excluded, to the detriment of the Canadian industry. As this example suggests, multilateral negotiations are often constrained by those countries least willing to liberalize trade.

Third, Canada and the United States may be willing to liberalize trade with each other on particular products but unwilling to extend the same degree of liberalization to third countries, which the GATT rules would require of them. In such cases, with multilateral bargaining, both Canada and the United States end up with very different trade barriers than they would have mutually adopted had they been bargaining bilaterally. In the Tokyo Round, for example, there was very little progress on reducing tariffs on petrochemicals, not so much because of concerns over Canadian-U.S. trade in these products but because of concerns over third-country suppliers.

What are the alternatives? One could be a supplemental agreement among those countries willing to liberalize trade. For example, in the case of procurement, it might be possible for the United States, Canada,

[18] D. Leyton-Brown, "The Multinational Enterprise and Conflict in Canadian-American Relations," *International Organization* 28 (Autumn 1974): 733–754.

and Japan to liberalize trade among themselves if Europe were unwilling. But this seems unlikely at the present time.[19]

Summary

Option four seems to us to be an insufficient reaction to present Canadian needs. Our reasons may be summarized in three points:

- The ability of GATT to bring about further significant multilateral trade liberalization seems open to enough question to make it overly risky to pin all of our hopes on the next round of GATT negotiations. If the negotiations produce little by way of trade liberalization, the Canadian government would be unable to produce a new bilateral initiative in response to this failure before the 1990s.
- We are not convinced by the negative argument that Canada is at a major disadvantage in bargaining bilaterally with the United States.
- We see many situations in which Canadian-U.S. bilateral negotiations would produce a result that both countries would regard as superior to that which could be achieved in negotiations involving all GATT members or smaller groups of industrial nations.

Option Five: Bilateral Trade Liberalization with the United States

Fully 78 percent of Canadian exports go to the United States, 7 percent go to Europe — including the United Kingdom — 5 percent to Japan, and 10 percent to the rest of the world. Of this last 10 percent, more than half takes place under various arrangements that are nonmarket determined.[20] Thus, over 80 percent of our market-determined exports go to the United States. Furthermore, the United States takes a disproportionate amount of our exports of end products — as opposed to agricultural products, and crude and fabricated materials. So, whether we like it or not, almost all of the action is in the U.S. market at present. While we should not give up any chance of encouraging trade with other areas

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[19] See, for example, P.T. Kilbourn, "Trade Fight with Japan," *New York Times*, March 29, 1985, pp. 1, 31.

[20] In 1984, only 11 percent of Canadian exports went to countries that were not members of the OECD. About one third of these exports went to centrally planned economies. Of the remainder, about one-fifth were aid financed (see A. Raynauld, J.-M. Dufour, and D. Racette, *Government Assistance to Export Financing* [Ottawa: Economic Council of Canada, 1983], pp. 27–29). Thus, over half of Canadian exports destined to non-OECD countries were nonmarket transactions.

— especially the expanding markets in the NICs — on a multi- or bilateral basis, the only current possibility for major increases in our trade lies with the United States.

Description

Although option five calls for the main Canadian effort on trade liberalization to be directed at the United States, it does not require exclusive concentration on that market. It could take place within the context of present multilateral trading arrangements and in conjunction with further multilateral trade negotiations. It would not exclude any bi- or multilateral initiatives for trade liberalization with other countries. Indeed, some people argue that a simultaneous effort directed at encouraging trade with the Pacific Rim and with developing countries would be an important signal accompanying bilateral agreements with the United States — a signal that just because it was entering into a new relationship with the United States, Canada did not intend to ignore trading relations with the rest of the world. For example, Canada could act to reduce some of the NTBs that it presently imposes on the exports of many developing countries. Nonetheless, this option would see our main effort directed toward trade liberalization with the United States.

Advocates of this option worry, along with the nationalists, that the Canadian economy may be hurt by the powerful economic forces currently causing rapid change throughout the world. They believe, however, that the best chance of allowing the Canadian economy to adapt effectively is to expose it to, rather than shield it from, the forces of international competition. They do not usually suggest as active and as detailed an industrial policy as do the advocates of the inward-looking option. Their view of the importance of trade liberalization with the United States does not, however, imply a particular stand on industrial policy. Indeed, the advocacy of many different kinds of industrial policy is quite consistent with the advocacy of major Canadian-U.S. trade liberalization.

Most advocates of this option believe that investment and output decisions taken by the private sector, operating through relatively free markets, are a better guarantee of economic success than are similar decisions taken by the public sector, operating through Crown corporations or through directives to privately owned firms. They see Canadian-U.S. trade liberalization, therefore, as part of a larger package of economic policies designed to increase the importance of the free market in determining investment and output decisions. Some of the other elements of the package are as follows:

- a strong competition policy designed to prevent privately owned firms from removing themselves from market pressures;
- a move towards selective privatization that would reduce the government's presence in market decisions; and
- a "climate style" industrial policy intended to set a favorable climate for growth while leaving decisions on which risks to take, and where and when to take them, strictly to the market.

Although these policies are often advocated as a package, this is not necessary. It would be possible, for example, to support trade liberalization with the United States while wishing to increase the number of Crown corporations, or while not believing in the value of a strong competition policy, or while taking almost any industrial policy stance.

Preliminary Assessment of the Options

There is a strong belief that the status quo — option one — is unacceptable because it is too risky. We agree with this perception.

We feel, along with what we are sure is the great majority of economists, that the inward-looking option — option two — is fraught with danger. Its chances of success seem small, and the consequences of its being adopted and failing would be so serious as to justify such strong words as catastrophic.

This leaves us with trade liberalization as the only possible direction in which to move.

The outward-looking option — option three — implies an interventionist policy, just as does option two. We reject option three both because it offers expansion to but a minute part of our total trade and because it seeks to increase trade by nonmarket, interventionist measures that have failed when used elsewhere.

Some will be willing to rely solely on the multilateral approach — option four. We worry, however, that the gains will be too little and too late. The next round of GATT negotiations will probably take place in the late 1980s and, if the Tokyo Round is any indication, several years may pass before any resulting trade liberalization actually occurs. In any case, the negotiations will probably take place in the present protectionist atmosphere and, thus, the trade-liberalizing results may be disappointingly small. Of course, we can hope for more progress, and Canada should do what it can to contribute to this, but the risk is still there.

So it seems to us to be unnecessarily risky to rely solely on the next round of GATT negotiations for the trade liberalization that we feel is

urgently needed.

Furthermore, as was illustrated by the example of the Tokyo Round of procurement negotiations, the GATT may not be the best vehicle for achieving trade liberalization with our most important trading partner: the United States. Neither can we expect the GATT to solve one of our most pressing problems: the strong incentive for Canadian firms wishing to serve the U.S. market to locate in that country in order to get under existing, and anticipated, U.S. trade restrictions.

This leads us to the conclusion that the only approach that promises a real chance for a major improvement is option five. This means pushing multilateral liberalization for all it is worth, but also pushing *now* for a major bilateral trade-liberalizing agreement with the United States. In the next chapter, we consider this option in detail. We assess its major variants, then list its important advantages, and, finally, consider the chances of its being implemented.

5

Bilateral Trade Liberalization with the United States

Improved access to the large U.S. market has been the dominant objective of Canadian commercial policy since Confederation. At the same time, Canadians have been concerned about the consequences of lower import barriers. In this chapter, we give a detailed consideration of option five: a major effort towards bilateral trade liberalization with the United States. The four subsequent chapters examine Canadian political, cultural, and economic concerns as well as exploring the issues involved in negotiating and implementing a free trade agreement.

Approaches to Bilateral Trade Liberalization

Our first task in this chapter is to look at several possible approaches that could be made toward the goal of bilateral trade liberalization with the United States. Policies to encourage Canadian-U.S. trade on a bilateral basis could take any one of three main forms:

- *The sectoral approach:* remove trade barriers in particular sectors. The autopact and the defense-sharing agreement are frequently cited as examples of what can be accomplished by such policies.
- *The functional approach:* deal with some of the policy instruments that restrict trade. An initiative to reduce nontariff barriers (NTBs) would be an example in this category.
- *The comprehensive approach:* reduce bilateral barriers to trade in an across-the-board manner.

The Sectoral Approach

In 1984 and early 1985, Canada and the United States engaged in discussions directed toward free trade arrangements in specific sectors. With the publication in January 1985 of the government's discussion paper,

How to Secure and Enhance Canadian Access to Export Markets, the sectoral approach seems to have been set aside.[1] However, since some may seek to revive this approach in the future, it is worth briefly summarizing the main objections to it.

First, it is hard to find sectors where the balance of advantages and disavantages will be about the same in both countries, yet political pressures have made it impossible to choose sectors where one country is the main beneficiary. Many of the big potential gains are in sectors where one country has much more to gain than the other — gains to both countries come from the net result of including many sectors where there are losses in some and gains in others. This need to avoid sectors where the balance of national gain is disproportionate will tend to exclude many of the sectors where there is most to be gained.

Second, to get agreement on any one sector and to fight that agreement through the political process would require great efforts. The resolution to proceed with such efforts could easily be sapped after only a few sectors had been covered.

Third, it is not clear that the necessary waiver by the General Agreement on Tariffs and Trade (GATT) could be obtained for sectoral free trade agreements. The autopact is not a precedent because at the time it was signed, the North American market was held to be segmented from the rest of the world market by virtue of the very different types of cars that were sold in each.

For these and similar reasons, critics of the sectoral approach held that it would not fulfill the need for a major liberalization of trade and that it might deflect attention from the efforts needed to initiate such a major change.[2]

The Functional Approach

Much interest has been expressed recently in a functional approach that would seek agreements to limit, or reduce, nontariff barriers on trade between the two countries. The federal government's 1985 trade discussion paper considers this as a major possibility, and it could be read

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[1] The Hon. J.F. Kelleher, *How to Secure and Enhance Canadian Access to Export Markets* (Ottawa: Government of Canada, January 1985).

[2] The sectors initially discussed were chosen, however, as case studies of the problems in reaching broader agreement. Thus, there is no reason in principle, although possibly there are many good reasons, in practice, why sectoral negotiations should not have proceeded while the run up to broader negotiations got underway — as long as they were not regarded as a substitute.

into the proposal by the Business Council on National Issues (BCNI) for a "trade enhancement agreement" (TEA).

The BCNI paper rejects the status quo option and then goes on to say the following about the proposed TEA:

> It represents the injection of political will into the *process* of liberalizing trade with the United States on a broader basis. It is complementary to, and builds upon, the sectoral trade talks which have already been initiated by the two governments. It would commit the two governments, as well as the respective private sectors, to an examination of the advantages and disadvantages of liberalized Canada-United States trade. It establishes a forum for discussion of trade matters which can defuse irritants before they become major problems. It would also provoke an intelligent and informed public discussion of this important dimension of our relations with the United States....It is *not* a proposition to create a free trade area with the United States, whereby all tariffs between the two countries would be gradually eliminated. Rather, it would allow the merits of this to be examined: the conclusion might very well favour such an option.[3]

Such approaches seem on the surface to have much to recommend them. They appear to offer major trade liberalization without going anything like all the way to a free trade association. We feel, however, that such functional arrangements are open to the same objections that led the government to turn away from the sectoral approach. Indeed, quite a strong case against the proposal seems to be implicit in the comments made about it in the government's 1985 consultative paper:

> In the functional approach, an important question is how an appropriate balance of advantages could be struck between those industries which would benefit from such arrangements and those which would face increased import competition. The fact that the tariff would remain and that the incidence of protection from tariff and contingency protection and non-tariff measures varies among industries makes a confident assessment of the scope for mutually beneficial functional arrangements difficult.
>
> In light of these considerations, an important question is whether sufficient political and private sector support could be mustered for individual agreements on a step-by-step basis or whether a comprehensive approach would better ensure positive results.[4]

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[3] Business Council on National Issues, *The Canada-United States Trading Relationship and the Idea of a Trade Enhancement Agreement: A Policy Proposal* (Ottawa, September 1984), p. 3.

[4] Kelleher, *How to Secure and Enhance Canadian Access to Export Markets*, p. 26.

We share these concerns, and in addition, we have the following further worries:

- Even if the agreements were reached, they would leave untouched all existing tariffs as well as, no doubt, many of the NTBs.
- Negotiations might start with the easy issues and never get to the difficult ones. Or, if they started with the difficult ones, they might, in the absence of an overall compelling agenda, not get beyond the first few.
- It would be hard to find specific trade-restricting policies where the net effect of advantages and disadvantages to each country were seen to be balanced. Yet this approach, like the sectoral one, would seem to require more or less even balances on each item.
- Because the negotiations would be on what to include, special-interest groups might have time to mobilize in favor of excluding just those cases where potential gains are large.
- For security of the arrangements, a treaty would be needed, but the inevitably piecemeal nature of such a treaty would invite detailed scrutiny and amendment by special interests in the U.S. Senate.

In conclusion, the advantages of this approach appear to us, on close examination, to be deceptive. They appear to allow the Canadian government to have its cake — that is, by avoiding something close to a free trade area — and eating it too — by getting substantial trade liberalization. We fear that the piece of trade-liberalizing cake Canada could obtain under these circumstances would be disappointingly small, and would be a long time in the cutting.

Nonetheless, this approach recommends itself to those in the government and in the private sector who wish to avoid hard choices. In our view, hard choices cannot be avoided. Any policy that tries to please everyone will end up doing little more than preserving the status quo, with some important but largely insufficient moves in the direction of more trade liberalization with the United States. If our worries prove well founded, negotiations based on a functional approach would serve merely to deflect attention from the need for major trade liberalization and to waste substantial amounts of time.

The Comprehensive Approach

We now come to comprehensive trade liberalization arrangements. Article XXIV of the GATT refers to such arrangements, which are subject to its approval, as "free trade areas". Since this is the terminology

that would have to be used in any approach to the GATT, we use it here. We realize, of course, that Canadian-U.S. trade will never be totally free. But the term "free trade area" states the desired result of being close to free trade, at least relative to anything that now exists.

A Canadian-American Free Trade Area

The arrangement that we consider under this heading is a "Canadian-American Free Trade Area" in the sense in which the term is used in Article XXIV of the GATT. For ease of exposition, we refer to it as a CAFTA.

In Chapters 8 and 9, we discuss the details of a possible CAFTA agreement. For our discusssion in the meantime, it is sufficient to think in terms of *a comprehensive agreement to remove all tariffs, and to reduce the effect of nontariff barriers, on substantially all trade in goods and services between the two countries.* This is the most ambitious scope for a CAFTA, and some restrictions in that scope would inevitably prove necessary.

What a CAFTA Is Not

We consider the advantages of a CAFTA in more detail below. First, let us notice what it is not. It is neither a customs union nor a common market. It is worth considering the distinction between a CAFTA and these two other arrangements because much of the past debate has confused them.

A Common Market

Of the three arrangements, the most complete form of integration is a common market. This arrangement has three characteristics:

- *no internal trade barriers:* there is free movement of goods and services among the member countries;
- *harmonized external barriers to trade:* there are common tariffs and harmonized external barriers against nonmember countries; and
- *no internal barriers to factor movements:* there is free movement of labor and capital among the member countries.

The second and third of these characteristics would make a common market between Canada and the United States unacceptable to Canadians. The second calls for a common set of trade barriers against all non-

member countries. However, Canada has not always wanted to follow U.S. initiatives on trade with the outside world, particularly when trade restrictions have been used for political purposes. Canadians who wish to maintain their independence in political and economic policy would never accept such a restriction on their freedom of independent action.

The third characteristic requires free movement of labor and capital among member states. Control over foreign immigration is a basic national policy, and the desire to maintain this control is sufficient to rule out a common market as acceptable to Canadians. Similar considerations apply to the requirement for a free movement of capital among the members of a common market. Although investment policies could be a subject of negotiation, both countries are likely to wish to control the flow of capital into sensitive sectors.

A Customs Union

A less comprehensive form of economic association than a common market is a customs union. It shares the characteristics of free internal trade and harmonized external barriers with a common market, but it does not include provisions for the free movement of labor and capital. Since we have already observed that the second of these characteristics — a common trade policy against nonmembers — would be unacceptable to Canadians, we must conclude that a customs union would be similarly unacceptable.

A Free Trade Area

The least comprehensive of these three arrangements is the free trade area. It shares with the other two arrangements the absence of internal trade barriers, but *not* the harmonization of external barriers and *not* the provisions for free factor movements. A free trade area, therefore, is concerned only with the free movement of goods and services among its members and avoids the restrictions to individual sovereignty that are implied by the conditions of both a common market and a customs union.

A process of elimination leads us to the conclusion that the only approach under option five — bilateral trade liberalization with the United States — that is capable of producing the desired major increase in trade liberalization, but that does not have characteristics that would be unacceptable to most Canadians, is a free trade area. The sectoral, functional, and process approaches seem to offer too little, while a customs union

and a common market require too much. From now on, a CAFTA is the only alternative that we discuss with regard to bilateral trade liberalization with the United States.

The Second-Best Nature of a CAFTA

A CAFTA is a second best in that it would not provide improved access for Canadian firms to markets other than in the United States. It is also second best in the technical sense that it would cause trade diversion. Consumers in each country would lose when buying from their CAFTA partner goods that could have been bought more cheaply from third countries. Much more serious, however, is the issue of trade diversion looked at particularly from the point of view of the developing countries. Trade diversion would mean lower sales from these countries to the North American market. We discuss possible action to avoid some of this harmful effect in a later chapter.

Advantages to Canada of a CAFTA

In this section, we outline some of the main advantages that Canada would get from a CAFTA:

- A CAFTA would have one *enormous* advantage over the other forms of bilateral arrangements previously considered: it would start out being *inclusive*, and negotiations would then be about *exclusions* both of goods and services and of particular trade-restricting instruments. It would not be necessary in such negotiations, therefore, to judge the balance of advantages sector by sector, or instrument by instrument. Instead, each country would recognize that it will achieve an overall gain, and exemptions would be restricted to areas where particular issues of national policy, or national sovereignty, arose.
- A CAFTA would provide the increase in trade liberalization that is needed to move Canada away from the status quo, and that is the main alternative to the inward-looking option of raising new barriers to trade.
- It would remove the remaining tariffs on Canadian-U.S. trade. Although the Tokyo Round has reduced tariffs substantially, remaining U.S. tariffs still exert a substantial restraining effect on Canadian exports to that country. Table 5 lists the average tariff rates for major industrial sectors in Canada and the United States.

Notice, however, that measures of average tariffs or of the volume of trade that moves duty free do not give an accurate picture of the ef-

fects of the complex structure of tariffs. The peaks and valleys of the tariff structure continue to distort bilateral trade flows in various ways. First, tariffs are particularly high on petrochemicals, textiles, fashion goods, clothing, and some types of electronic and telecommunications equipment [5] Second, existing U.S. tariffs inhibit Canadian exports most strongly in the "up market" type of manufactured commodities

TABLE 5
Post-Tokyo Round Tariffs on Industrial Products by Sector: Canada, United States, and All Industrial Countries
(percentage)[a]

Sector	Canada	United States	All industrial countries
Textiles	16.7	9.2	8.5
Wearing apparel	24.2	22.7	17.5
Leather products	6.3	4.2	3.0
Footwear	21.9	8.8	12.1
Wood products	3.2	1.7	1.9
Furniture and fixtures	14.3	4.1[b]	7.3
Paper and paper products	6.7	0.2	4.2
Printing and publishing	1.0	0.7	1.5
Chemicals	7.5	2.4	6.7
Rubber products	6.7	2.5	4.1
Nonmetal mineral products	6.4	5.3	4.0
Glass and glass products	7.2	6.2	7.9
Iron and steel	5.4	3.6	4.4
Nonferrous metals	2.0	0.7	1.6
Metal products	8.5	4.8	6.3
Nonelectrical machinery	4.5	3.3	4.7
Electrical machinery	5.8	4.4	7.1
Transportation equipment	1.6	2.5	6.0
Miscellaneous manufactures	5.4	4.2	4.7
All industries	5.2	4.3	5.8

[a]Weighted by own-country imports, excluding petroleum.
[b]Estimated from incomplete data.

Source: A.V. Deardorff and R.M. Stern, "Economic Effects of Complete Elimination of Post-Tokyo Round Tariffs," in W. R. Cline, ed., *Trade Policy in the 1980s* (Washington, D.C.: Institute for International Economics, 1983), pp. 674–675.

[5] Ibid., p. 20. See also Canada, Office of the Coordinator Multilateral Trade Negotiations, *Multilateral Trade Negotiations 1973–1979: Canadian Participation* (Ottawa, 1979); and United States, *Trade and Tariff Act of 1984.*

into which we need to be moving if we are to avoid competing with the low-income countries in the production of low-value-added commodities. Third, because tariff rates increase with the degree of processing, the *effective* rates of duty are much higher than the nominal rates. The differential between effective and nominal rates is particularly high on finished goods. These high effective rates reduce the incentives to manufacture in Canada goods that use Canadian raw materials but that are destined for the U.S. market.[6]

- Not only would a CAFTA eliminate tariffs, it would also reduce non-tariff barriers and clarify their applicability. This would help to remove the uncertainty that currently exists among firms and, we strongly suspect, among all levels of Canadian government as to which actions are and are not countervailable or subject to other NTBs.
- A CAFTA would provide Canadian firms with secure access to a market of over 250 million people. This would then allow them to achieve competitive costs based on large economies of scale and long production runs resulting from a narrower range of products than is now produced.
- The low costs achieved in this market would make it easier to export to third countries so that, although Canada would conduct a higher proportion of its trade with the United States, it would also increase its trade with the rest of the world.
- Achieving world-competitive costs now would leave Canadian industries poised to compete in the expanding markets of the newly industrializing countries and Japan — especially when that country becomes a

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[6] The distinction between the nominal and effective rate of tariff is most easily shown in an example. Consider a product manufactured in both Canada and the United States from a Canadian raw material, where the raw material enters the United States duty free but the manufactured good is subject to a 10 percent tariff. When the product is manufactured in Canada, the raw material accounts for half the cost of the final product and the other half is the value added by the Canadian manufacturer. Because of the tariff, a unit of the product that represents a dollar's worth of Canadian output will sell in the United States for $1.10. Next, consider the position of a U.S. manufacturer. Assume that the U.S. firm is not as efficient as the Canadian firm, so that its production costs are 20 percent higher. This means that, to produce the same unit of output, the raw material costs the U.S. firm $0.50, but its other costs — including its mark up — are $0.60. This gives the U.S. firm a final price of $1.10, which is just low enough to compete against the tariff-burdened Canadian import. This example shows that a tariff of 10 percent on the value of the final product has been sufficient to protect a U.S. manufacturer that is 20 percent less efficient than its Canadian competitor.

mature creditor with the excess of imports over exports such status implies. If such cost competitiveness is not achieved now, we may be left behind as these third markets expand over the next decade.

- By achieving costs and prices now available in the United States, Canadian living standards would undergo a rise of something between 4 and 7 percent. (Since the evidence for cost-reducing, scale effects seems strong to us, we believe the actual number would be close to the top of this range.)
- Gains, although hard to measure, would result from a wider range of products becoming fully available to Canadian consumers. This was an important effect of the European Community.
- Once a CAFTA exists, or is anticipated with a reasonable degree of certainty, a new generation of Canadian investment — still in its early stages — would take place in a known trading environment. A clear signal would be given to invest in ways that make sense in an integrated North American environment. Although nothing is ever certain, a treaty-bound CAFTA would provide much more planning security to firms wishing to service the North American market from Canada than does the present regime, in which there is uncertainty about the NTBs that the United States will attempt to use to restrict imports from Canada.
- The removal of trade barriers would eliminate one of the incentives of Canadian firms to locate plants in the United States to avoid existing, or anticipated, NTBs. It would also remove one important reason for the worrying flow of employment-creating Canadian direct investment to the United States.
- The removal of trade barriers would eliminate any remaining incentive for U.S. firms to set up branch plants or subsidiaries to serve only the local Canadian market. U.S.-owned subsidiaries would still exist, but they would tend to specialize in the production of certain lines sold in Canada and in other parts of the world.
- Taken together, these last two points suggest that there is a reasonable chance that a CAFTA would result in an increase in Canadian ownership of Canadian industry.
- As Canadian production patterns change, new employment-creating investment opportunities would be created. This would help offset the unemployment-creating effects of the transition.

This is an impressive list of advantages. No other option seems to us to offer anything approaching such gains.

Advantages to the United States of a CAFTA

The U.S. administration's evident current interest in major trade liberalization with Canada raises the question of the reasons for that interest. Some Canadians may wonder if Americans have enough self-interest to carry them through the undoubtedly long and difficult path to fruition. Others may wonder if U.S. self-interest stems from considerations that do not suggest mutual benefit.

The economic significance of Canada to the United States is often underestimated. As of 1983, U.S. direct investment in Canada had a book value of U.S.$47.5 billion, accounting for about 30 percent of U.S. direct investment in the industrial countries. In 1983, U.S. exports to Canada amounted to U.S.$43.8 billion, or 22 percent of U.S. exports. In comparison with other major trading partners, Canada's share of U.S. exports was double that of Japan and exceeded that of the ten-nation European Community. At the same time, Canadian exports accounted for 21 percent of U.S. imports. The United States thus has an obvious and substantial interest in Canada's economic prosperity.

We see five particular advantages of a CAFTA for the United States:[7]

- The Canadian market is important to U.S. firms. Some Canadians ask why U.S. firms should worry about so small a market. But a market of an additional 25 million people, added to a market where costs are already being covered, can make a disproportionate contribution to profits.
- Access to the Canadian market is particularly important for U.S. firms that are introducing new products. Integration of the high-per-capita-income North American market would reduce the risk of introducing new products and thus enhance the capability of North American-based firms to compete with rivals in Japan and Europe.
- Canada is still the most important location for U.S. foreign investment. Secure, treaty-protected trade and investment relations with Canada would help to create additional security for that investment.
- The United States is worried about the worldwide resurgence of protectionism. A CAFTA would provide a major demonstration that the force had not gone out of the U.S. push for further trade liberalization. The demonstration effect would be partly a generalized matter — "see, it really is possible" — and partly a very specific example — a model

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[7] S. Weintraub, "U.S.-Canada Free Trade: What's in It for the U.S.?" *Journal of Interamerican Studies and World Affairs* 26 (1984) 225–244.

for trade liberalization elsewhere. This "model" aspect is one of Canada's greatest protections against being exploited in bargaining situations — at least for those who fear this possibility. The U.S. wish to keep the agreement as close as possible to the desired model of trade liberalization would be a check on the power of U.S. special-interest groups — and, one would hope, on Canadian groups as well — to force the acceptance of provisions that are undesirable from the broader viewpoint. It also would provide some restraint against attempts by the United States, should it be needed, to maximize its own national self-interest at the clear expense of Canada.

- Canadian prosperity is desirable to the United States. A northern neighbor that was politically unstable, economically depressed, or in a state of social upheaval would be a serious worry to U.S. policymakers. Anyone who doubts this should recall the concern that suddenly developed in the United States when Quebec separatism became evident after the election to power of the Parti québécois in 1976.

The Window of Opportunity

Twice before in this century, the possibility of some type of free trade arrangement has been seriously debated. Both times it was Canadian initiative that terminated the discussions.

U.S. Interest

Once again, there is little doubt this time about U.S. interest. The Reagan administration has made it clear that it would like Canada to make an approach -- believing it is more appropriate for Canada to do so than the other way around. There seems a reasonable chance that a CAFTA could get through the U.S. Congress. As time passes, however, the opportunity is slipping away. Protectionist sentiments are growing in the United States; while Congress is always sensitive to these sentiments, it is likely to become more so as the mid-term elections approach, and after the next presidential election a new administration also may be more responsive to protectionist interests and less inclined to exempt Canada from these measures.

In the United States, the balance between those who favor trade liberalization and those who favor protectionism is particularly delicate now. The negotiation of a free trade area offers the potential for cooperation among some of these interests as a means of putting increased pressure on the United States' trading partners to open up their markets without

the need to resort to import restrictions. As the President's Council of Economic Advisers states:

> Perhaps most importantly...the possibility of FTA [free trade area] or, more broadly, plurilateral negotiations offers the United States and others the option of using a free-trade instrument, rather than protectionism, as a lever against protectionist countries that are recalcitrant in fully multilateral negotiations. This distinction is important because there are several fundamental difficulties with using trade sanctions to persuade other countries to liberalize their trading practices. First, trade sanctions hurt the country that imposes them, in some instances as much as, or more than, the foreign country. Second, the foreign trading partner knows that this is the case. As a consequence, threats of trade sanctions are often not credible. Then, of course, there is always the additional threat of foreign retaliation.[8]

Canadian Interest

In Canada, the Progressive Conservative government has been given a large majority that can be interpreted as a mandate for economic change. Electors may have been unsure about what exactly needed to be done, but a general feeling that some drastic changes were needed seems to have been evident in the election. This proposal for a CAFTA will undoubtedly spark debate and arouse some of the deep-seated fears that are the subject of the next two chapters. It will be much easier for the government to become involved in this process when it is closer to the last election than to the next.

Another very interesting development is the changing attitudes of Canadian firms to the possibility of a CAFTA. The BCNI, which represents many of the largest firms in the country, is sympathetic to schemes for trade liberalization with the United States, and its approach is not inconsistent with a CAFTA.[9] The Canadian Manufacturers' Association (CMA), whose constituency includes smaller firms than those in the BCNI, has come out as being quite favorable to something close to a CAFTA. In its 1984 publication, *A Future That Works*, the CMA recommends,

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[8] United States, Executive Office of the President, *Economic Report of the President, Transmitted to the Congress February 1985, together with the Annual Report of the Council of Economic Advisers* (Washington, D.C.: U.S. Government Printing Office, 1985), p. 126.

[9] Business Council on National Issues, *The Canada-United States Trading Relationship*.

> that Canada explore all means of securing dependable and preferential access to the U.S. market consistent with the GATT, including the current sectoral approach as well as giving consideration to entering into a trade agreement with the United States under Article XXIV of the GATT. Issues for consideration should include tariffs, rules of origin, safeguards and adjustment assistance, as well as non-tariff trade barriers.[10]

This is a major shift from the CMA's stand of a decade ago and no doubt reflects an increase in business confidence since then, when most of its members feared that a CAFTA would do them serious harm.

For all of these reasons, a clear "window of opportunity" now appears to be open. What is uncertain is how long it will remain open if Canada does not soon put forward a decisive initiative. There is even more uncertainty about when it will open again if it shuts this time. Another opportunity in this decade seems unlikely, and some observers worry that there may not be another in this century.

Conclusion

A comprehensive Canadian-U.S. trade liberalization arrangement might stop short of a full free trade area, but there is a serious danger in starting negotiations with less-than-complete free trade on the table. If the negotiators start with something less, the decision on what to include will be subject to political decisions before the bargaining table is ever reached, and the bargaining will very probably back off further from the ideal of complete free access to each other's markets. This twofold process would greatly increase the risk that the final outcome would be an agreement too narrow in scope, and too circumscribed with exceptions and escape clauses, to provide the significant trade liberalization that is needed.

These considerations lead us to two major conclusions:

- Bilateral trade liberalization with the United States should be accepted as Canada's immediate policy goal, and negotiations to this effect should start as soon as possible.
- The goal should be to obtain freedom of access for each country's output to the other's market — but on a timetable that allows ample time for the necessary readjustments to occur in an orderly fashion. Thus,

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[10] Canadian Manufacturers' Association, *A Future That Works* (Toronto, September 1984), p. 43.

the objective of the negotiations should be for a broad-based, free trade area.

Canadian Concerns

If there is such a strong case to be made for a CAFTA, why are the majority of concerned Canadians not urging free trade negotiations on their government now? Of course, some Canadians accept the inward-looking option. They would have our trade policy do an abrupt reversal to the National Policy of the nineteenth century. We suspect that, although many Canadians share some of the nationalists' worries, far fewer would go all the way with the plan of turning Canadian policy inwards, thereby risking the serious political and economic problems that would arise from a trade-barrier war with our largest trading partner.

It is our experience that many more Canadians, while rejecting the inward-looking option, share deep worries about closer economic association with the United States. They fear that such association would lead to a major erosion of Canada's cultural identity, its political independence, and its economic integrity. These are serious concerns for all of us who share the strong desire to maintain Canada's strength, its independence, and its uniqueness. In the next two chapters, we consider some of these general worries — worries that hold many concerned Canadians back from a course whose economic advantages they accept.

A further group of Canadians, while accepting the principle of free access of each country's products to the other's markets, feel that negotiations for any treaty seeking to give effect to such a concept would run into insurmountable problems, or, if surmounted, would cause a major erosion of Canadian sovereignty. These issues are discussed in Chapters 6 and 7.

PART III

Concerns and Issues

6

Political and Cultural Concerns

Like it or not, Canada is a small country living next door to a giant. As a result, most Canadians hold ambivalent views about the United States. On the one hand, Canadians know that if we cut off all commercial, social, and political association with the United States, we would lose overwhelmingly. Thus, we realize that we must learn to live with, and actively cooperate with, a presence we cannot ignore. On the other hand, we wish to keep our distance. Most of us share a deep-seated fear of being swallowed up culturally, economically, and politically by the U.S. colossus.

These worries prevent many Canadians from endorsing the idea of a Canadian-American Free Trade Area (CAFTA) even when they are convinced of its economic advantages. In this and the next chapter, we address these worries insofar as they are relevant to a CAFTA. We stress that we ourselves wish to see Canada retain as much cultural, economic, and political independence as is reasonably possible. We stress also that we see many ways in which we Canadians might wish to distance ourselves from the United States in order to preserve our independence in one aspect or another. We do not address these possibilities here. Instead, we ask only what is relevant to the present study: How might a CAFTA affect Canadian cultural, economic, and political independence?

Our conclusion is that many of these worries are either unfounded or else surmountable. We reach this conclusion not because we wish to diminish the validity of the concerns about our independence in general but because we find that the specific institutions of a CAFTA need not bring serious harmful *changes* to our cultural integrity, our political sovereignty, or our economic independence.

The emphasis on changes stresses an important point. If we are to assess the effects of a CAFTA, we must have clearly in mind a "base case": a situation that will persist if the CAFTA is not formed. Being clear about the base case is important, because many of the worries expressed to

us about the consequences of a CAFTA actually turned out, on close study, to be worries about the present situation. To avoid such confusion, we must be sure that a worry is really directed to the consequences of a change that can be attributed to the introduction of a CAFTA, not either to something that is inherent in the present situation or that will result from a development that would occur even if the CAFTA were stillborn.

Political Issues

The terms of any agreement between two sovereign countries imply some curtailment of freedom of action. In a CAFTA, both sides would give up the right to make certain unilateral decisions — just as, for example, do all members of the General Agreement on Tariffs and Trade. The detailed losses of sovereignty that might be entailed by the specific terms of a CAFTA are discussed in Chapters 8 and 9. In this chapter, we deal with more general concerns, and we start with the most extreme one

Wouldn't close economic association with the United States result in a political union?

The worry expressed. Mitchell Sharp is one of the best known of the modern exponents of this view. In 1972, he wrote:

> This option [a CAFTA] has been rejected in the past because it was judged to be inconsistent with Canada's desire to preserve a maximum degree of independence, not because it lacked economic sense in terms of Canadian living standards and the stability of the Canadian economy.[1]

In 1984, he reiterated the point in these words:

> To enter into a free trade arrangement with the United States is to alter fundamentally the direction of Canadian policy, not so much in economic terms as in political terms, and Canadians are not prepared to do so.[2]

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[1] M. Sharp, "Canada-U.S. Relations: Options for the Future," *International Perspectives* (Special Issue, Autumn 1972), p. 15.

[2] M. Sharp, "Canada's Independence and U.S. Domination," in E.R. Fried and P.H. Trezise, eds., *U.S.-Canadian Economic Relations: Next Steps?* (Washington, D.C.: Brookings Institution, 1984), p. 17.

Doubts about the effects of a CAFTA. This point is commonly asserted but seldom argued. Indeed, it is hard to understand the rationale of a process whereby a reduction of tariffs from an average rate of somewhere between 5 and 10 percent to zero, plus the elimination of some significant nontariff barriers (NTBs), would lead to political union. When we compare trade barriers with those that have existed in the past between many countries, including Canada and the United States, our two countries are seen to be close to free trade now. Yet, no one has identified a loss of political independence compared with the former high-tariff days. If the reduction of tariffs from the former high levels to the present low ones did not cost us our political independence then, why should the reduction from the present low levels to zero do so now?[3]

Evidence from other countries. When we look to precedents elsewhere, we can find no historical experience to suggest that a high degree of trade liberalization between two countries leads to their political integration.[4] Nor do we know of any experience to suggest that a small country cannot trade freely with a large one without losing its political independence.

The experience of the European Community (EC) is instructive. On the one hand, the EC is very different from the CAFTA case because it contains several small as well as several large countries. On the other hand, being a common market rather than a free trade area, the EC represents a much closer arrangement than anything contemplated between Canada and the United States. (This is so even though the reality of the EC has fallen short of its objectives.) Finally, and most interestingly, the early postwar fathers of the Community, such as Belgium's Spaak and France's Monnet, hoped that the logic of the emerging economic association would force closer political association, and that this would end in something approximating a United States of Europe. Yet,

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[3] Fears that the details of arrangements designed to reduce or eliminate NTBs will seriously erode our sovereignty are considered in Chapters 8 and 9.

[4] Two cases that are occasionally quoted to the contrary are the German Zollverein, which predated German unification in the nineteenth century, and the U.S. annexation of Hawaii after that country had been penetrated by U.S. commercial interests. Bismarck's unification of Germany probably would have occurred without the Zollverein. As for the sorry tale of U.S. colonialism in Hawaii, it belongs to another era, and we might just as well worry that the United States will attempt such behavior in Canada as that it will embark on another Mexican War with the object of annexing yet another Mexican province.

this political union, in spite of being wanted by the participants, never came close to being achieved.

In view of all this experience, it seems hard to believe that a much less comprehensive association than the EC — one that made much less drastic changes in trade barriers and that was between two countries wishing to retain their independence — would end up forcing on either partner a political association that it strongly opposed.

U.S. attitudes. So far, we have said nothing about U.S. desires for political union with Canada. The Canadian worry has the United States eagerly waiting to gobble up Canada politically. Somehow this view seems to us to be just a bit naive in the light of U.S. political institutions, practical U.S. politics — think of all those new seats in the Senate! — and the long, difficult struggle to bring into the union those two willing supplicants, Alaska and Hawaii.

Canadian political independence improved by a CAFTA. Canada's present dependence on U.S. markets indeed makes it quite vulnerable to U.S. policy shifts. A CAFTA would formalize Canada's economic relationship with the United States in a way that would make it less liable to suffer from sudden, unilateral shifts in U.S. policy. This would *reduce* Canadian vulnerability and, therefore, *increase* the room for independent Canadian political maneuver.

Canadian political resilience. Those who doubt Canada's political resilience should study the case of the independence movement in Quebec. The United States fought a bloody civil war over the right of the southern states to secede. Spain, France, Yugoslavia, and a host of other countries seek to suppress the separatist movements of minorities. Canada is rare among nations in allowing a plebiscite on separatism, and a plebiscite where only the province considering secession voted! The rarity of this Canadian experience, the highly civilized nature of its conflict-resolution process, and the resilience of its institutions was never clearer than during the Quebec separatist issue. Yet, such is the ingrained Canadian inferiority complex that few Canadians recognized they had participated in a process whose civilized nature was almost unparalleled.

Surely, wouldn't the rest of the world believe that a free trade area has made us a U.S. political and economic satellite, and wouldn't we lose world influence as a result?

There are more realistic fears here. On the one hand, a Canadian government might wish to return to the halcyon days when Nobel Peace Prize winner Lester B. Pearson presented Canada's face abroad as honest broker. On the other hand, it might wish to come much closer to the kind of all-out support for U.S. foreign policy that is given, say, by the current U.K. government.

Political constraints. First, consider possible new constraints that a CAFTA might put on Canadian political action. It would seem that any Canadian government has both of the above options open to it, and that these options can be exercised quite independently of the level of restrictions on Canadian-U.S. trade. We see no reason to believe that the existence of a CAFTA would make it any more difficult for Canada to take as independent a line in foreign affairs as it has done over the past 40 years.

On the contrary, a CAFTA would prevent the United States from using commercial policy to express its disapproval of some Canadian political initiative — something it has done to other countries. For example, if the United States currently disapproved of some new Canadian policy for trade with Cuba, it could seek to retaliate by ending its favorable treatment of Canada with respect to import-restricting policies such as the voluntary export restraints on autos and steel. The terms of a CAFTA treaty, however, would rule out such policy shifts.

Political image. Next, consider possible changes in Canada's external political image. This is a more subtle worry: if we lie down with the United States in a commercial bed, would we not lose credibility as an independent political force in the eyes of other countries? This worry is difficult to assess because it depends on opinion, rather than on fact. After all, there is a strong strain of anti-Americanism in many countries.

It seems to us, however, that after an initial post-CAFTA adjustment period is over, our perceived independence from U.S. foreign policy depends on the conduct of our foreign policy. On the one hand, if Canada took strong and independent lines that sometimes risked U.S. disfavor, Canadian foreign policy would be perceived as being independent of the United States — even if our rates of tariff on trade with each other were mostly zero. On the other hand, if we closely followed, and supported, every twist and turn of U.S. foreign policy, we would be perceived as being a U.S. satellite, *even if our rates of tariff on trade with each other were very high.*

The italicized point is important. Few Canadians believe that high

tariffs would save us from being thought a U.S. political satellite if we acted like one. Then, by the same token, we should believe that, in the long haul, low tariffs would not prevent us from being perceived as politically independent if we acted independently.

Commercial policy. So far, we have discussed political issues. No doubt third countries would correctly perceive Canada as being even more closely linked economically to the United States than it is now. Possibly this would cause Canada to be more dependent on the United States when it comes to commercial policy. Were we to enter into a customs union, this would surely be true. The two countries would then have to harmonize their policies on trade restraints with third countries, and there would be little doubt which country's views would predominate in setting the common external policy. But this need not happen with a CAFTA. Canada would continue to be free to operate its own independent policy on trade relations with the outside world, and we suspect that it would act independently. Indeed, we fear that, once the U.S. dollar returns to something closer to its purchasing power parity rate, Canadian policy might become more restrictive than U.S. policy with respect to third countries. Whether the policy is right or wrong, this worry suggests independence. So, on the question of actual independence, we believe Canada would retain substantial independence of action with respect to third countries. On the question of the perception of third countries of Canadian independence, we suspect that, in the long term, this would depend on how much Canada exercises that independence in practice.[5]

Social and Cultural Concerns

Some very difficult issues involving specific cultural support policies will arise when the details of any arrangement are negotiated. These are discussed in Chapters 8 and 9. Here we deal with the broader concerns.

Wouldn't a CAFTA seriously erode Canada's cultural independence?

Attitudes to this concern depend on how one views the present state of Canadian culture.

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[5] The political pressures that might arise from a threat of abrogation are examined in Chapter 9.

Views on Canadian Culture

- There are those who seriously tell us that there is no independent Canadian culture. For them there can be no concern about erosion.
- The rest of us believe that, although there are many similarities between Canadians and Americans, based partly on their sharing similar national experiences — experiences which are very different from those of Europeans — there are also many significant cultural differences between them.
- Some Canadians believe that the characteristics that differentiate Canadian from U.S. culture are fragile. They worry, therefore, that these differences are subject to serious erosion as a result of minor changes in the behavior of ordinary Canadians. Examples would be reading more U.S. magazines or watching more U.S. television programs.
- Finally, there are those who believe that there is a separate and deeply rooted Canadian culture.

We are inclined to this last view, and the evidence gathered by such empirical sociologists as Seymour Lipsett persuades us of two key points.[6]

First, Canadians and Americans are divided by some profound differences in attitudes on a host of matters, ranging from such broad issues as global defense strategy, the welfare state, and respect for, and trust in, the police, down to such details as minor infractions of the law and the type of hero we tend to identify with in novels. Of course, there are differences among Americans and among Canadians, and one can find some Canadians who hold the typical American attitude on any particular matter. But attitude surveys, as well as other evidence, such as divorce rates, church attendance, and what is written in novels, show the typical Canadian attitude on issue after issue to be significantly different from that of the typical American.

The second point is that there are plausible reasons for believing that these attitudinal differences are deep rooted and, hence, will be resilient to such culturally homogenizing forces as reading the same magazines and watching the same movies and television shows. The reasons for these documented cultural differences will always be open to debate, but some of them surely lie, as explained by Lipsett, in our very differ-

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[6] R.G. Lipsey, "Canada and the United States: The Economic Dimension," and S. Lipsett, "Canada and the United States: The Cultural Dimension," both in C.F. Doran and J.H. Sigler, eds., *Canada and the United States: Enduring Friendship, Persistent Stress* (New York: Prentice-Hall, 1985).

ent heritages. There is space to mention only two illustrations here.

First, consider the way in which each country achieved political independence. The United States has a revolutionary background. During the American Revolution, however, Canada received the Loyalists, who rejected the revolution and instead chose allegiance to the British Crown. Les canadiens were also conservative in their values and outlook. Reflecting these social characteristics, Canada's political independence was the result of a process of devolution, not revolution.

Second, consider the timing of foreign immigration. Massive immigration changed the face of U.S. society in the nineteenth century. Until well after World War II, however, the Canadian population — although not, of course, every Canadian area — was dominated by people whose forebears came from France or the British Isles. Then, in the postwar world, under a very different social climate than that which greeted nineteenth century immigrants to the United States, Canada opened its doors and became a genuinely multiracial society.

Evidence from Other Countries

Of course, every nation's experience is in some ways unique, but some evidence about the deep-seated worry that we are considering can be gained from looking at other countries. Even within the United States, there is no doubt about the continued existence of separate regional cultures. The Old South, New England, the Midwest, California, the Pacific Northwest, and the Sun-belt states each show strong, and apparently resilient, cultural divergences. These differences persist within the confines of the U.S. common market, which is a much more embracing type of economic association than anything contemplated in a CAFTA.

Turning to different countries of disparate size, we may consider the British Isles. In spite of a very close economic association that included a monetary union until the mid-1970s, Irish culture never was overwhelmed by English culture. No visitor to Cork or Dublin could ever think he or she was in Manchester or London. Of course, the antagonisms of history will hold the Irish and English apart politically, but the relevant point for the present discussion is that a very much closer economic association than the one contemplated between Canada and the United States did not lead to greater Anglicizing of Irish culture.

Conclusion

So, having considered these worries with some care, they seem to us

to be extreme. We find it hard to believe that the relatively small changes in trade policy that are being contemplated would threaten the extinction of what is distinctively Canadian about Canadians. We believe that Canadian culture is unique; that the roots of its uniqueness are set deep in the Canadian experience; and that this uniqueness will not be threatened by doing a bit more trade with the United States, any more than it would be threatened by a little more exposure to U.S. media.

Wouldn't a CAFTA reduce, or destroy, some of the private markets, and eliminate some of the public policies, that support many of Canada's cultural activities?

We now come to some less dramatic, and possibly more well-founded, worries. Canadian government support for broadly defined cultural activities is substantial. Three main reasons can be identified for such support policies:

- although the product can be sold on the market, the local market is just not large enough to support the activity — at least with the degree of diversity policymakers think desirable;
- the market is large enough, but the share that would go to Canadian producers in open competition with U.S. producers is not large enough to support them; and
- an objective of public policy is to produce a different product than would emerge if the product had to be sustained by free-market activity.

The first case involves subsidies to support a host of "up-market" cultural activities such as theaters, art galleries, museums, and orchestras. A CAFTA would create no problem with respect to any of these activities. They are subsidized in many countries, and there is nothing in the conditions of a typical free trade area that would interfere with such support.

The third case is typified by the Canadian Broadcasting Corporation. Its product would be very different if its revenues depended only on advertising and other commercially determined sources. Consider one of the main policies used to change the nature of the product: the Canadian-content rule that applies to radio and television. Insofar as such a rule is needed, it is because the commercial incentives would produce less Canadian content. This puts Canadian media at a disadvantage when competing in the marketplace against U.S. media and, therefore, the rule

would not conflict with the principles of a free trade area, which do not prohibit measures that put one's own industries at a competitive disadvantage.

Increasing the Canadian Share of a Viable Market

Problems arise with the second case. Here, the market is large enough to sustain some activity — say, the publishing of several weekly news magazines. But given the share of the market that U.S. magazines would obtain in open competition, the volume of sales available to Canadian magazines would be below the minimum needed to sustain some of the Canadian publications. The same argument applies to television stations. There is room for one or more stations in an area, but given the volume of advertising that Canadian firms would place with U.S. stations, there would not be enough advertising revenue to sustain some of the existing Canadian stations.

Canadian support policy could then take one of two basic forms. Either some method could be found to transfer to Canadian firms the revenues that would otherwise be earned by U.S. firms, or a subsidy — either direct or indirect — could be given to allow Canadian firms to survive with the sales that they can make in open competition with U.S. firms.

Whatever the reasons, Canadian support policy has often provided direct restrictions on foreign competition rather than subsidies to Canadian producers. Consider a few of the most important of these.

Canadian newspapers, periodicals, books, recordings, radio stations, films, and television broadcasters receive substantial support. Federal sales taxes are remitted; concessionary postal rates are given; importation of foreign periodicals with more than 5 percent of their advertising expressly aimed at Canada is prohibited; direct financial assistance goes to Canadian publishers; there is much provincial support of Canadian-owned publishers; there is still a 15 percent tariff on imported finished records and tapes; and there is substantial, but varying, support of the film and television industries, especially through the tax system.

Bill C-58

Under Bill C-58, Canadian-based companies are not allowed to deduct advertising expenses incurred with non-Canadian media for advertising aimed at Canadian audiences. This applies to print media — newspapers and periodicals — and to television and radio broadcasters. Qualifying as "Canadian" requires satisfying both Canadian-ownership and

Canadian-content requirements.

When this bill was first passed in the 1970s, it caused a furor south of the border. The law is probably inconsistent with any concept of free trade in services, since it puts U.S. media at a serious disadvantage in competing with Canadian media for Canadian advertising dollars. Assuming that Canadian border stations could not stand up to open competition with U.S. border stations for advertisers' dollars — about which, more below — and assuming that Canadian magazines could not stand up to competition from Canadian editions of such U.S. magazines as *Time*, we may then ask: Are there other policies that would allow these Canadian media to survive, but that would not come into conflict with the conditions of a typical free trade area?

Tax Incentives versus Subsidies

In principle, most things that can be done with tax incentives, or with quantity restrictions, can also be done with direct subsidies. There is little doubt, for example, that those Canadian border stations, magazines, and periodicals which could not otherwise cover costs could be kept in business with an appropriate government subsidy. Furthermore, such a subsidy would be less likely to encounter U.S. opposition than did Bill C-58. The U.S. government has never suggested that it would object to direct Canadian subsidies for this purpose. Such subsidies would not, for example, stop U.S. border stations competing for Canadian advertising dollars on open terms with Canadian stations. Such subsidies could be lump-sum grants, or they could be given on a per-unit basis related to readership or listening audience, thus rewarding success. In principle, they could also be given through the placement of sufficient government advertising to increase revenues to a viable amount.

If one takes a rational view of policy, there would be some advantage to using the subsidy approach. It is open, and its cost could, therefore, be readily calculated. It would allow users to choose freely among competing U.S. and Canadian products. If consumers showed very little interest in the Canadian product, the support might be reconsidered, while if the Canadian product showed itself able to maintain a significant part of the market, the subsidy would more likely be regarded as worthwhile.

Other methods of subsidization could no doubt be invented. The problems with any subsidy plan, however, is in its political acceptability. Special-interest groups prefer direct restrictions on the ability of U.S. producers to compete. This is because restrictions have concealed costs that are not easy to calculate and, therefore, are less likely to arouse public

objection. Also, restrictions might protect the Canadian product from serious competition, and thus allow it to sustain itself even if it became inferior to the foreign product on all counts.

Furthermore, governments do not like direct subsidies because they place the cost within the government's budget, while regulatory methods place the cost on the private sector. Special-interest groups do not like subsidies because, by making the degree of subsidization obvious and the payments subject to government review, the net effect is often less support than when the cost is hidden and diffused throughout the private sector.[7]

The Border Broadcasting Case: An Illustration

The key assumption in the advertising tax case is that intervention is needed to preserve the financial viability of many border radio and television stations. However, an internal government study paper casts some doubt on this premise. After a careful study of the facts, the paper concludes that the increase in total revenues of all border television stations due to Bill C-58 was $30 million, which, according to the paper, is about 4 percent of the total revenues of all the affected stations.[8] Furthermore, the U.S. border stations expressed a willingness to pay Canadian taxes by setting up Canadian subsidiaries, and prorating their revenues, so that

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[7] The enormous technological changes that are going on in the communications field will have serious ramifications for any support policy that is followed by the Canadian government. Commentators analyzing cultural policies have stressed the significance of the rapid pace of technological change that is occurring in the electronic media as a result of satellite transmission and the diffusion of videocassettes (see S. Globerman and A. Vining, "Bilateral Cultural Free Trade: The U.S.-Canadian Case" [Simon Fraser University, Vancouver, 1984, Mimeographed]). On the one hand, new technology is steadily reducing the distribution cost of certain types of cultural services, such as television, sports, and videocassettes. Thus, freer trade could result in even greater saturation of Canadian electronic media by U.S. content. On the other hand, these same shifts in technology are lowering the costs of reaching specialized audiences. Hence, independent Canadian producers will face lower cost barriers to reaching those special segments of the more fragmented markets in both countries. Regardless of the net effects of technological change on the level of production of Canadian cultural industries, these trends to fragmentation and specialization are likely to render the existing set of trade restrictions obsolete. Given the rapid pace of technological change, subsidy policies are likely to be more robust in achieving the desired production levels than are quota restrictions.

[8] A. Donner and M. Kliman, *Television Advertising and the Income Tax Act: An Economic Analysis of Bill C-58*, Draft Report (Ottawa: Department of Communications, November 1983).

revenue from Canadian sources would be taxed in Canada.[9] Thus, we begin to doubt that the principal effect of the policy was to support stations that would otherwise have failed. Different consequences, which have been so often found in other cases of government regulatory behavior, suggest themselves.

Here are the points that now seem relevant to this case:

- Stations for which a 4 percent increase in revenue made the difference between survival and demise must have been rather marginal in any case. One must wonder — and would want to see a station-by-station enumeration — if the survival of such stations was really worth the cost, in terms of international friction, that Bill C-58 imposed.
- Many stations that were going to survive in any case were given a bonus by the advertising revenues that Bill C-58 transferred to them. Considering the wealth of the owners, this was hardly a transfer of income from rich to poor!
- As we have already observed, the bill had no further justification as a device for closing a tax loophole. The U.S. stations are now prepared to adopt institutions that would make their advertising revenue from Canadian sources subject to Canadian tax.
- In 1984, the United States finally passed mirror legislation, doing to Canadian stations what Bill C-58 did to U.S. stations.[10] This has at least two effects. First, it reduces the subsidy to marginal stations, to the net effect that the two countries' laws have on their advertising revenues. This may mean that even fewer stations owe their actual existence to Canadian tax provisions. Second, it hurts those Canadian border stations that have been successful in penetrating the U.S. market.

So the effect of Bill C-58 may be similar to the proven effects of so many other government regulatory policies. The bill probably meant the difference between success and failure to only rather marginal stations, while increasing the profits of the owners of stations that would have survived in any case. Furthermore, by encouraging mirror legislation, the bill may have hurt those successful Canadian stations that are able to penetrate the U.S. market and, incidentally, that help to disseminate Canadian culture in the United States by giving a hearing to Canadian artists that they would find it hard to get from U.S. outlets.

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[9] D. Leyton-Brown, *Weathering the Storm: Canadian-U.S. Relations, 1980–83*, CAC no. 51 (Toronto; Washington, D.C.: Canadian-American Committee, 1985).

[10] United States, *Trade and Tariff Act of 1984*.

Conclusion

This long discussion of cultural support policies leads us to the following conclusions:

- many existing cultural support measures would not need to be changed because of a CAFTA;
- those measures that work through restricting competition on a national discriminatory basis would be hard to reconcile with the terms of a CAFTA;
- some of these measures may be much less effective in meeting genuine cultural support needs than is sometimes believed;
- in any case, alternative methods that would provide the same degree of support, and that would be compatible with a CAFTA, are usually available.

Beyond that we cannot go, because the decision on alternative means of support is clearly a political one. It is then up to the political process to select from the available alternatives those that are politically acceptable.

Summary

In this chapter, we have looked at some of the worries about the effects of a CAFTA on Canadian political and cultural independence. Our conclusion is that the change from the current position of low trade restrictions to the extreme of zero trade restrictions would not seriously change our present position with respect to our cultural and political independence. Where specific support policies would be ruled out by the terms of a CAFTA, alternative policies are usually available. When alternatives are not available, exemptions for the policies should be arranged during the CAFTA negotiations. Indeed, at the outset of any CAFTA negotiations, the principle should be established that Canada has a right to support cultural activities that would otherwise not survive in the vaster U.S. market.

7

Economic Concerns

Canadians have many deep-seated worries about the economic effects of a greatly increased liberalization of trade with the United States. They are concerned about the economic pressures on Canada that could result from increased economic integration with the United States.

One set of worries pertains to the implications of free trade for particular industries. What would be the costs of adjusting to increased international competition? Would firms be able to retool their operations? How many jobs would be displaced?

Another set of worries pertains to the longer-term implications of freer trade. Would Canadians become "hewers of wood and drawers of water"? Would foreign capital flood into Canada, increasing the already-high level of foreign ownership? Would foreign firms retrench, and would Canadian firms invest in the United States? Would Canada's capability for industrial innovation be impaired? Would Canada be obliged to harmonize its tax and income distribution policies with those of the United States?

Transitional Problems of Adjustment

Wouldn't the dislocations caused by increased international competition be very serious, with whole industries and areas going into decline, so that the long-term gain would be outweighed by the shorter-term losses?

This is one of the most serious worries that we continue to hear expressed. It raises some basic issues that we must consider at length. To do so, we first analyze the nature of international competition in many industries where firms compete on the basis of product quality and design as well as price. We then examine the record of Canadian industrial and trade performance. Finally, we consider some illustrations of how particular industries might cope with the pressure of international competition.

In considering the impact of freer trade, it is important to realize that the economy is always changing. Adjustments are being made continually as new products and sometimes entire new industries arise, while old products and sometimes entire old industries decline or disappear. Even within an apparently stable industry, producing goods which change only slowly, new firms continually emerge while some older firms disappear.

In 1970, for example, the average Canadian industry contained 85 firms. By 1979, that average industry had experienced 38 deaths and 25 births of firms. So, in spite of a net reduction of 13 in the number of firms remaining in the industry — and an increase in the average size of those that remained — there had been twice that number of new entrants.[1]

Thus, the total number of entries and exits of firms in the typical industry is large, and changes in the size of the industry, or in the size of the firms, tend to be accomplished by small differences between the rates of entry and exit of firms.

International Competition with Product Differentiation

The variety of the product lines produced by the typical manufacturing industry has a profound effect on the adjustments that tariff changes impose on it.

Economics textbooks, and popular commentators, often assume that industries produce a single product: wheat, or sheet steel, or some uniform grade of cloth. In fact, most manufacturing industries produce a vast range of products of differing styles, grades, and uses. For example, even for a relatively simple product like paper, there are hundreds of different weights, grades, colors, and uses. Similarly, numerous models of cars, dozens of types of detergents and cleansers, and an ever-changing number of home computers can be bought in Canada today.

A large number of products does not, however, necessarily imply a large number of firms. In some industries, this vast range of products is produced by a very few firms — for example, there are only four North American car manufacturers, while three firms dominate soap sales. In other industries, there are many small firms. In both cases, however, the number of individual products is large. Thus, the typical industry

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[1] Economic Council of Canada, *The Bottom Line: Technology, Trade and Income Growth* (Ottawa: Supply and Services Canada, 1983), p. 116.

produces a vast range of differentiated products, whether it contains many or few firms.

European experience. Product differentiation has important implications for the process of adjustment to lower trade barriers. To gain some insight into these implications, let us first look at some recent history. Here, the experience of the European Community (EC) is useful. Negotiations for the EC took place in the 1950s, culminating in the Treaty of Rome in 1958. It provided for the complete removal of barriers to the exchange of goods and services moving among the member countries. When the treaty was signed, there was great concern about the potential dislocation of industries caused by the removal of each country's import protection.

This worry turned out to be exaggerated. One reason was that the significance of product differentiation had not been fully appreciated. Policymakers were implicitly working with the textbook model of one-product industries and, hence, they expected that whole industries would disappear in particular countries. Thus, West Germany might come to dominate one industry, while France came to dominate another, Italy yet another, and so on. To accommodate these expected major adjustments, the treaty scheduled tariffs to be reduced slowly at a rate of 10 percent per year for five years, with a provision for review before proceeding with the complete elimination of tariffs and quotas.[2]

As the tariff reductions proceeded, however, whole industries did not disappear. Instead, each country tended to specialize in particular product lines within any one industry. It did not happen that France produced all the wine, while West Germany produced all the cars, and Italy all the fashion goods. Instead, the wine, car, and fashion goods industries survived and prospered in all three countries. The industries in each country found the specialized products for which they had a comparative advantage, either for natural or acquired reasons. Each national industry then specialized in those product "niches". As a result, trade did not consist of the products of each industry flowing in one direction from the producing country to the consuming countries; instead, it consisted of specialized products in any one industry flowing from producers in each country to consumers in all the other countries. Thus, French wine, cars, and fashion goods were exported to West Germany and Italy; West German wine, cars, and fashion goods were exported to France and Ita-

[2] *Treaty Establishing the European Economic Community* (Treaty of Rome), 1957.

ly; and Italian wine, cars, and fashion goods were exported to France and West Germany. Most other manufactured goods also followed this pattern.[3]

As a result, the effect of the EC was not quite what had been anticipated. As it worked out, the range of consumer choice was broadened greatly; national specialization was by individual differentiated products within each industry; and the type of national specialization by whole industries that policymakers envisaged and worried about seldom occurred. This had the effect of making national adjustments to the lowering of tariffs very much less than had been expected. Indeed, the disruption was so small that the timetable for tariff reduction was accelerated. In 1960, the EC decided to increase tariff reductions to 20 percent per year and to eliminate all quotas by the end of 1961.[4]

Canadian experience. Next, let us look at some Canadian history. Substantial Canadian trade liberalization took place in the 1966–72 period as a result of the phasing in of tariff reductions negotiated in the Kennedy Round of the General Agreement on Tariffs and Trade (GATT). Analysis of Canada's trade and industrial performance indicates that trade liberalization in the 1970s resulted, just as it had in Europe, in more trade within particular industries.[5] Canadian firms rationalized by reducing the number of their product lines and attaining competitive costs on a much smaller range of products. Many of these products proved to be exportable, while the abandoned lines necessitated imports. The net effect, therefore, was an increased amount of intra-industry foreign trade between Canada and the United States. Even textiles displayed this kind of intra-industry adjustment.

Some industries did see imports grow relative to exports, although even in these industries, exports grew — they just grew less than imports. Since these industries experienced a decline in net exports as a proportion of total production, some shrinking in their relative size did occur. In other industries, the reverse happened. Resource-based industries such as wood products and paper, which were already substantial

[3] B. Balassa, *Trade Liberalization among Industrial Countries: Objectives and Alternatives*, Council on Foreign Relations Atlantic Policy Studies (New York: McGraw-Hill, 1967), Chapter 1.

[4] United Kingdom Information Service, *Freeing Trade in Europe* (London: Swindon Press, 1960), p. 8.

[5] See D. MacCharles and B. Wolf, "The Role of Intra-Industry Trade in Canadian Manufacturing" (Paper presented to the North American Economics and Finance Association Meetings, San Francisco, December 1983).

net exporters, did increase net exports modestly. The most dramatic gains, however, were in industries such as chemicals, machinery, and rubber and plastics products, all of which were significant net importers during the 1960s.

These adjustment patterns are shown in Tables 6, 7, and 8. Looking first at Table 6, we see that every manufacturing sector, with the single exception of knitting mills, increased the proportion of its total produc-

TABLE 6
Export Orientation of Major Manufacturing Sectors in Canada, 1966–81
(percentage of production exported)

Manufacturing sector	1966–73	1973–80	1981
Food and beverages	9.7	10.8	12.6
Tobacco products	0.6	0.6	0.7
Rubber and plastics	5.0	9.5	13.8
Leather industries	5.7	7.7	7.4
Textile industries	4.8	6.3	8.2
Knitting mills	2.3	1.7	1.7
Clothing industries	4.3	5.0	6.5
Wood industries	43.3	48.2	47.0
Furniture and fixtures	3.7	6.6	10.6
Paper and allied industries	50.7	56.0	59.9
Printing and publishing	1.9	2.9	3.3
Primary metal industries	46.1	47.7	54.4
Metal fabricating industries	3.9	6.3	7.3
Machinery industries	37.8	49.0	54.4
Transportation equipment industries	60.4	69.3	68.4
Electrical products industries	13.0	17.2	24.4
Nonmetallic minerals	6.9	9.6	10.6
Petroleum and coal products	3.7	7.4	8.9
Chemical and chemical products	15.3	22.8	29.0
Miscellaneous manufacturing industries	22.2	20.5	26.5
Total Manufacturing	*24.3*	*28.4*	*30.0*

Note: All values are in current dollars. Trade data are on a customs value basis, Trade of Canada. The trade data have been allocated to industrial sectors according to the 1970 Standard Industrial Classification. Shipment data for 1966–1979 are Census of Manufacturers. In 1980 and 1981 shipments data are derived from Inventories, Shipments and Orders in Manufacturing, Statistics Canada. Shipments are synonymous with "production".

Source: Canada, Department of External Affairs, *A Review of Canadian Trade Policy: A Background Document to Canadian Trade Policy for the 1980s* (Ottawa: Supply and Services Canada, 1983), p. 30.

tion that was exported. Overall, Canadian manufacturing firms exported 24 percent of their total production in the 1966–73 period and 30 percent in 1981.

Table 7 shows that every sector, with the single exception of petroleum and coal products, had an increase in the proportion of the Canadian market supplied by imports. Overall, 25 percent of the sales in Canadian manufacturing markets were served by imports in the 1966–73 period and 32 percent in 1981.

TABLE 7
Import Penetration of Major Manufacturing Sectors in Canada, 1966–81
(percentage of Canadian market supplied by imports)

Manufacturing sector	1966–73	1973–80	1981
Food and beverages	7.3	9.6	9.0
Tobacco products	1.1	1.5	1.7
Rubber and plastics	17.8	22.9	22.2
Leather industries	21.3	32.6	33.0
Textile industries	23.9	27.0	26.8
Knitting mills	21.8	30.5	30.1
Clothing industries	6.9	11.3	13.7
Wood industries	9.2	11.7	11.2
Furniture and fixtures	6.4	11.9	12.6
Paper and allied industries	6.2	9.6	11.4
Printing and publishing	13.5	14.3	14.4
Primary metal industries	23.9	30.0	40.0
Metal fabricating industries	13.2	15.1	15.1
Machinery industries	66.3	87.0	76.2
Transportation equipment industries	61.6	72.3	71.9
Electrical products industries	26.7	36.6	41.9
Nonmetallic minerals	15.0	17.2	18.6
Petroleum and coal products	9.5	4.0	3.9
Chemical and chemical products	25.6	31.3	31.4
Miscellaneous manufacturing industries	50.1	54.4	57.5
Total Manufacturing	*25.5*	*30.6*	*31.6*

Note: All values are in current dollars. Trade data are on a customs value basis, Trade of Canada. The trade data have been allocated to industrial sectors according to the 1970 Standard Industrial Classification. Shipment data for 1966–1979 are Census of Manufacturers. In 1980 and 1981 shipments data are derived from Inventories, Shipments and Orders in Manufacturing, Statistics Canada. Shipments are synonymous with "production".

Source: Canada, Department of External Affairs, *A Review of Canadian Trade Policy: A Background Document to Canadian Trade Policy for the 1980s* (Ottawa: Supply and Services Canada, 1983), p. 31.

The message of these data is impressive: as trade barriers have been reduced, both our exports and our imports have increased in virtually all sectors. This supports the "niche" concept. Whole industries have not disappeared in either country. Instead, each industry has specialized in particular niches so that trade has increased in each direction, in each industry.

Now consider Table 8. This table shows for each sector its net exports — exports minus imports — as a proportion of its total production. Comparing the 1966–73 period with 1981, half of the industries listed increased their ratio of net exports to domestic production, while the other half reduced theirs. This is just what we would expect from the operation of comparative advantage. Some industries have expanded exports relative to imports while others have contracted.

TABLE 8

Shifts in Trade Orientation for Canadian Manufacturing Industries, 1966–81

Manufacturing sector	1966–73[a]	1981[a]	Change[b]
Food and beverages	+ 2.4	+ 3.6	+ 1.2
Tobacco products	− 0.5	− 1.0	− 0.5
Rubber and plastics	−12.8	− 8.4	+ 4.4
Leather industries	−15.6	−25.6	−10.0
Textile industries	−19.1	−18.6	− 0.5
Knitting mills	−19.5	−28.4	− 8.9
Clothing industries	− 2.6	− 7.2	− 4.6
Wood industries	+34.1	+35.8	+ 1.7
Furniture and fixtures	− 2.7	− 2.0	+ 0.7
Paper and allied industries	+44.5	+48.5	+ 4.0
Printing and publishing	−11.6	−11.1	+ 0.5
Primary metal industries	+22.2	+14.4	− 7.8
Metal fabricating industries	− 9.3	− 7.8	+ 1.5
Machinery industries	−28.5	−21.8	+ 6.7
Transportation equipment industries	− 1.2	− 3.5	− 2.3
Electrical products industries	−13.7	−17.5	− 3.8
Nonmetallic minerals	− 8.1	− 8.0	+ 0.1
Petroleum and coal products	− 5.8	+ 5.0	+10.8
Chemical and chemical products	−10.3	− 2.4	+ 7.9
Miscellaneous manufacturing industries	−27.9	−31.0	− 3.1

[a]The ratio of exports to domestic production in each industry (as shown in Table 6) minus the ratio of imports to domestic production in each industry (as shown in Table 7). A positive number denotes a net export orientation for the industry, while a negative number indicates a net import position.

[b]This column records the shift in the industry's net export position.

The overall effect of successive rounds of Canadian tariff reductions has been to increase both import and export propensities for major industries. The shift in net export positions has been modest for most industries. This is just as it was in Europe, and for just the same reason — because so much of the adjustment was intra-industry.

Implications for Canada

The Economic Council of Canada expresses the implications of these observations for adjustment to a CAFTA as follows:

> Nobody is advocating that free trade be implemented overnight; thus massive dislocation and job displacement are not likely. The evidence indicates that if gradual tariff reductions continue to be made along the lines agreed upon during the Kennedy and Tokyo Round negotiations, the layoffs that occur would likely be small, when compared with the total labour force in the manufacturing sector....
>
> The results of the analysis of the firm and labour market experience in adjusting to greater import competition do not suggest that the "doomsday scenario" — massive unemployment, increased imports without any offsetting increase in exports, and scrapping of plants — is near reality. On the firm side, the most significant findings show that changes in birth rates of new plants dominate changes in death rates in the adjustment process. On the labour side, adjustment is also less traumatic than might have been thought. Indeed, as the Task Force on Labour Market Development remarked, 'although the need for labour force adjustment is expected to be great, a review of Canadian experience to date indicates that Canadian workers have substantial ability to adjust.' An important *caveat* must be mentioned with respect to women, older workers, unskilled workers, and those with fewer years of education — all of whom have greater than average difficulty to adjust. On the other hand, most workers do find jobs and display considerable mobility between sectors and between occupations.[6]

Liberalization of Canadian-U.S. trade is particularly likely to be dominated by intra-industry, not inter-industry, adjustment because of the similarity of per capita income levels in the two countries.[7] The Canadian industries that have lost domestic market share — leather, clothing, knitting mills, and consumer electronics — are those that are experiencing increased competition from lower-income countries. At worst, trade liberalization with the United States might accelerate the decline of these

[6] Economic Council of Canada, *The Bottom Line*, pp. 122–123.

[7] See E. Helpman, "International Trade in the Presence of Product Differentiation, Economies of Scale and Monopolistic Competition: A Chamberlin-Heckscher-Ohlin Approach," *Journal of International Economics* 11 (1981): 305–340.

industries. In some cases, however, the greater opportunity to specialize for the larger North American market would establish these industries in particular product niches and help them to compete with imports from developing countries.

The high level of foreign ownership of Canadian manufacturing industries raises the question of how, and whether, multinational companies would respond to lower trade barriers. Some evidence on this issue is available from a study by Don Daly and Don MacCharles. They interviewed 15 foreign-owned and 15 Canadian-owned firms drawn from five manufacturing industries: electrical products, chemicals and plastics, machinery, auto parts, and miscellaneous. They conclude that both foreign-owned and Canadian-owned firms respond to trade liberalization by product specialization. Twenty-six of the 30 firms indicated that by expanding production of key products, they could lower unit costs by at least 10 percent.[8] It is notable that the Canadian-owned firms tended to respond more quickly to improvements in export market access.[9] But Canadian subsidiaries indicated that their higher unit costs were the most important barrier to exports to the parent multinational. Only four of the 15 subsidiaries indicated that head office policies inhibited their exports.[10] This evidence suggests that successful adjustment to tariff cuts is likely and, if anything, that it would encourage the expansion of Canadian-owned over foreign-owned companies.

Some Illustrations of Canadian Industrial Adjustment

Individual firms and industries are likely to experience significant increases in the degree of competition as trade barriers are reduced. In this section, we sketch some of the possible adjustment responses of particular industries. The first illustration is the Canadian fine paper industry, which is presently coping with Tokyo Round tariff reductions. The second illustration is the textiles and clothing sector, which was largely excluded from Tokyo Round tariff cuts and which would experience significant adjustment if it was included in the coverage of a CAFTA.

The fine paper industry. During the Tokyo Round, Canadian trade negotiators were subject to two conflicting pressures in negotiating tariffs on

[8] D. Daly and D. MacCharles, "Canadian Manufactured Exports: Constraints and Opportunities" (York University, Toronto, 1984, Mimeographed), p. 138.
[9] Ibid., p. 178.
[10] Ibid., p. 196.

paper products. On the one hand, Canada wanted reduction of foreign tariffs on paper products, particularly in the U.S. market. On the other hand, Canadian producers feared that significant reductions in Canada's high tariffs on imported paper products would eliminate the profitability of many relatively small plants producing a wide range of grades of book and fine paper for the domestic market.

In the end, Canada obtained significant reductions of the U.S. tariffs. The bargaining quid pro quo, however, was a significant reduction in Canadian tariffs.

What was the result of this gamble? As Canadian and U.S. tariffs have come down, Canadian producers have launched a major rationalization program. Since the sale of paper products is very price sensitive, the producers have been compelled to reduce costs. They are doing so by reducing he number of paper grades produced and substantially expanding capacity in order to reap economies of scale in the product niches that they still occupy. As the Forest Industry Task Force states:

> Three companies in the U.S. each manufacture more paper than the entire Canadian fine paper industry. The main problem in Canada is the lack of rationalization and specialization in an industry with 7 companies manufacturing almost the same number of grades (120–150) as the U.S. industry.
>
> The liberalization of trade between Canada and the U.S. in the [Tokyo Round] will result in new adjustment challenges for the industry. Further rationalization and modernization is required to capture economies of scale and specialization and to take advantage of improved market access to the United States. The rationalization now underway is a major step forward.[11]

The Canadian industry will emerge with plants that are comparable to most U.S. plants in their scale and product specialization. So here we see at work all of the factors that were discussed earlier:

• Freer trade did not result in one country's industry overwhelming the other's. Instead, each country's industry specialized in certain product niches. The Canadian industry greatly reduced its number of product lines, but its success in the remainder more than compensated in terms of output, so that the industry is emerging with higher output and lower costs than was the case before the tariff cuts.

[11] Forest Industries Advisory Committee, *Interim Report to the Hon. Edward C. Lumley, Minister of Industry, Trade and Commerce and Regional Economic Expansion* (Ottawa: Supply and Services Canada, August 1983), p. VII–29.

- The industry is poised to compete — when the Canadian and U.S. dollars fall back to their purchasing-power parity rates — in markets for paper outside of the United States.
- The industry is no longer as uncompetitive as it once was, and it is no longer as dependent on a protected home market for its survival.

The textile and clothing industry. This industry illustrates some of the important adjustment issues that would arise from freer Canadian-U.S. trade. As Table 4 (see Chapter 5) clearly indicates, the textile and clothing industries in both Canada and the United States have high tariffs, and they will remain high after all the Tokyo Round tariff reductions are implemented. In addition, both countries are members of the Multifiber Arrangement — which limits imports of textiles and clothing — and have significant nontariff barriers to limit imports from "low-cost" supplier countries.

The report of the Canadian Textile and Clothing Board observes that:

- Canada and the United States have substantial bilateral trade in textiles and clothing despite high tariffs. The U.S. market absorbed one-half of Canadian textile exports and two-thirds of Canadian clothing exports.[12]
- On average, labor compensation levels in these industries are comparable on both sides of the border.[13]
- The complexity of U.S. textiles and clothing tariffs constitutes an important nontariff barrier to Canadian exports.

The Board report states:

> Canada imports textile products from the United States with unit values substantially and systematically higher than the unit values of its exports to that country. While Canadian producers can make basic products in sufficient volumes to make it economically worthwhile, the more specialized products are often imported from the United States, where the domestic market is large enough to allow production on a sufficiently large scale. In contrast, Canadian textile exports to the United States are confined to basic products, along with very few specialized products.

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[12] Canada, Textile and Clothing Board, *Study of the Impact of Potential Free Trade in Textiles and Clothing between Canada and the United States, Final Report* (Ottawa: Supply and Services Canada, 1984), p. 24.
[13] Ibid., p. 14.

> For clothing, the exact opposite applies. Canada exports products with a high unit value to the United States while it imports from the latter large quantities of basic apparel at relatively low unit values. Even with relatively high tariff protection in the United States the Canadian producers of high quality clothing manage to find outlets in the United States, although their share of this market is still very small. In contrast, the United States producers have an advantage over Canadian producers with regard to standard clothing items: their long production runs allow them to produce at very low costs.[14]

There would likely be substantial restructuring of this sector, particularly in Canada, if the high tariffs were gradually phased out for bilateral trade. Canadian manufacturers of specialty clothing could be expected to expand production, and the Canadian textile industry would have to specialize in particular product niches and thereby exploit scale economies. Although the increased competition that would occur in a CAFTA might be resisted by parts of the industry, this restructuring would improve the capability of the sector in both countries to compete with offshore suppliers.[15]

Conclusion

A CAFTA would certainly present serious adjustment problems. However, the evidence of the past behavior both of the Canadian economy and of other countries where major tariff reductions have occurred, plus what we know about industries with a large number of differentiated products, suggests that the adjustment problems may not be as serious as is often believed.

Nonetheless, Canadians will continue to worry about this issue, and will correctly perceive that the adjustment problem is more serious for Canada than for the United States because a much higher proportion of Canadian GNP is produced by foreign trade. For this reason, we advocate, in Chapter 9, that U.S. trade barriers be reduced faster than Canadian barriers to permit a slower adjustment in Canada than in the United States. We believe that this proposal should be enough to reassure even those who take a more pessimistic view of the adjustment problem than we do. Early access for Canadian firms to the U.S. market would strengthen the expansionary and adaptive process in Canada. Predicta-

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[14] Ibid., pp. 25–26.

[15] P. Morici, *The Global Competitive Struggle: Challenges to the United States and Canada*, CAC no. 50 (Washington, D.C.; Toronto: Canadian-American Committee, 1984), pp. 69–70.

ble and gradual access for the United States to the Canadian market would allow for an orderly contraction where that proves necessary.

Wouldn't the adjustment process greatly increase Canadian unemployment?

There is an unfortunate tendency in Canada to judge every policy by its immediate effect on employment. Yet any growing, changing economy must make adjustments. Some firms, industries, and sectors decline while others expand. Governments attempting to preserve employment have often been tempted to prop up firms, industries, and even whole sectors that would otherwise decline. But such policies, intended to preserve jobs, have the cumulative effect of reducing employment opportunities. By attempting to preserve existing jobs and, hence, to freeze the current industrial structure, the economy's employment-generating capability is inhibited. By opening up new markets and causing cost-reducing rationalizations, a CAFTA would increase the economy's ability to generate employment opportunities while no doubt eliminating some particular jobs.

The overall level of unemployment is strongly affected by Canadian monetary and fiscal policies, interest rates, world prices for Canadian exports, and the exchange rate for the Canadian dollar. The very large fluctuations in all of these forces that have occurred over the last decade have had a much larger impact on the pattern of employment than is likely to result from the gradual reduction of existing Canadian trade barriers.

Nonetheless, the movement towards freer trade would no doubt accelerate somewhat shifts in the pattern of employment. Older and less mobile workers tend to be the most vulnerable to any changes in employment. Special adjustment assistance measures could be used to ensure that these, and other especially vulnerable groups, do not bear a disproportionate share of the cost of adjusting to freer trade. Some specific measures are discussed in Chapter 9.

In summary, a CAFTA would increase employment opportunities, while no doubt eliminating some specific jobs; its impact would, however, be small compared with that of such disrupting forces as large shifts in interest rates, commodity prices, and exchange rates. In any case, the impact on individual workers could, and should, be cushioned by special public policy initiatives.

Longer-Term Pressures

What would be the longer-term consequences of CAFTA? Would Canada become deindustrialized? Would foreign ownership of the Canadian economy increase or decrease? Would R & D increase or decrease? These are the questions to which we now turn.

Wouldn't Canada revert to being specialized in resource industries?

Possibly, although not everyone agrees, Sir John A. Macdonald's National Policy was needed to get Canadian manufacturing industry firmly established in the late nineteenth and early twentieth centuries. Be that as it may, the worry expressed above refers to what is needed to keep the Canadian economy diversified — and not dependent on a narrow range of resource industries — in the late twentieth and early twenty-first centuries.

Some Canadians believe that the only measures preventing us from reverting en masse to a nation of "hewers of wood and drawers of water" are import barriers, behind which manufacturing can thrive. But what effect do Canadian and U.S. trade barriers really have on Canadian manufacturing?

Canadian trade restrictions currently protect some Canadian manufacturing activities and, hence, also protect some employment in these activities. The numbers, however, are not as significant as is often thought. As the Economic Council of Canada puts it:

> The number of jobs saved in the manufacturing sector because of protection has been estimated at 40,000 for 1978. Total employment in that sector was 1.8 million, up 166,200 from 1966, when the Kennedy Round [of GATT tariff] reductions began to be implemented.[16]

At the same time, U.S. trade restrictions discourage Canadian manufacturing that is designed to supply the U.S. market. For example, the nominal rates of U.S. tariffs are significantly higher on our manufactured goods than on our raw materials and semimanufactured goods. As was discussed earlier, effective rates of tariff greatly exceed nominal rates on manufactured goods. Thus, the structure of U.S. tariffs creates a substantial barrier to the export of high-value-added products. U.S. tariff and nontariff barriers create incentives for Canadian firms to invest in

[16] Economic Council of Canada, *The Bottom Line*, p. 122.

the United States, not Canada. The simultaneous removal of both countries' tariff and nontariff barriers would encourage some, and discourage other, lines of manufacturing activity. Since U.S. trade barriers protect higher-value-added activities ranging from resource processing to high technology, the net effect of their removal would likely be an increase in Canadian manufacturing activity. Answering the question posed above, the net effect of the existing Canadian and U.S. trade barriers is probably to reduce the amount of manufacturing that occurs in Canada.

When considering the effects of a CAFTA on the diversification of the Canadian economy, it is important to realize that its introduction would not require any major change in the direction of Canadian trade policy. Since the 1950s, Canada has been reducing its tariffs as a result of GATT negotiations.

The adjustment to tariff reductions has thus been going on for a long time, and so far, there has been no apparent tendency for Canada to become deindustrialized. Indeed, from 1950 to 1984, employment in Canadian manufacturing increased by 785,000.

Far from supporting the conclusion that freer trade leads to a specialization in resource industries, Canadian manufacturing exports have thrived as trade barriers have come down. The share of Canadian exports that consists of manufactured end-products has increased to about 42 percent in the early 1980s from about 8 percent in 1960 (see Table 2). Important issues remain, however, with respect to how individual firms or particular industries cope with increased international competition.

Wouldn't U.S. capital flood into Canada, increasing the extent to which Canada is an economic satellite of the United States?

It is important once again to have a sense of the pre-CAFTA, "base case". Canada has always been closely tied to the United States economically and, by virtue of geography and resource endowments, it will continue to be so into the indefinite future. Public policy can at best make only small changes either way in this relationship.

Note also that this worry was much stronger in the 1970s than it is now. With or without a CAFTA, there is more worry today about having sufficient supplies of foreign capital to finance employment and growth-creating investment in Canada than about having too much foreign capital. What effect then would a CAFTA have on foreign ownership?

The Economic Council of Canada has argued that, during the transition period, foreign ownership might increase because multinationals would have more resources at their disposal to make rapid adjustments to serve growing markets than would domestic Canadian firms.[17] One way to counter this would be to allow more mergers among Canadian firms so that they could "scale up" to more efficient sizes. Another countering force would result from a major reduction in the federal government's deficit. Fewer Canadian savings would then be siphoned off into dead-weight government debt, and more would be available to supply loan and equity capital to expanding Canadian firms.

In the long term, the rationalization of Canadian production would permit longer production runs. This would lower both per-unit costs of production and the amount of capital needed per unit of output. As a result, Canadian GNP would rise and Canadian savings would rise with it. So there would then be two forces operating: the amount of capital needed per unit of output would be falling; and Canadian savings available for investment in Canadian firms would be increasing as a result of the rise in GNP — and hopefully also because of the fall in the federal deficit. As a consequence, there would be room for more, rather than less, Canadian ownership of Canadian output capacity.

Wouldn't capital desert Canada and flood into the United States?

This is one important aspect of the general worry, that Canada will lose its industrial base. Our consideration of this particular worry is organized under six points.

Worries About Capital Movements in Either Direction Are Mutually Exclusive

First, notice that we cannot simultaneously be concerned with U.S. capital flooding into Canada *and* Canadian capital fleeing to the United States. Either there is a worry that a CAFTA will lead to an influx of foreign capital, or there is a worry that it will lead to an outflow. One can hold that neither, or that one or the other of these, is a serious concern, but not both.

Today's Major Concern Is Too Little Foreign Capital

Second, notice that the more common worry today concerns insuffi-

[17] Ibid.

cient employment-creating foreign capital, not a surfeit. We have already referred to the outflow of Canadian capital caused by direct investments in the United States made by Canadian firms in order to gain secure access to the U.S. market. Just as the tariffs imposed by Sir John A. Macdonald's National Policy led to the establishment of U.S. branch plants and subsidiaries in Canada, so actual and anticipated U.S. non-tariff barriers — among other causes — are pulling Canadian investments, and the jobs they create, into the United States. This is a worrying development.

A CAFTA that was broad enough to increase the security of access of Canadian exporters to the U.S. market would remove, or at least substantially reduce, this important reason for the outflow of Canadian capital. This is one reason, therefore, for believing that a CAFTA would lead to an increase in the amount of Canadian capital invested in Canada. This would alleviate the worries about capital movements described above. The reduction in Canadian direct investment in the United States would increase the amount of capital staying in Canada, and simultaneously reduce the proportion of Canadian industry that is foreign owned.

Forces Holding Foreign Capital in Canada

Third, we note that there are several forces that would encourage foreign capital to stay in Canada after the formation of a CAFTA:

- Existing plants cannot be moved, so they would not be closed as long as they were able to cover their current operating costs. This would tend to hold U.S. capital in Canada in the short term.
- The taxation system would exert a significant pressure on foreign-owned firms to remain in Canada. Depreciation write-offs would create an incentive for firms to reinvest their cash flows in Canada. So, any ongoing operation whose management chose to move production to the United States would have to pay a large capital levy to do so.[18]
- Most direct foreign investment in Canada now comes from the retained earnings of existing foreign-owned companies, rather than from new

[18] The following hypothetical example indicates the significance of these tax effects. Suppose a company has purchased a machine to be used in its manufacturing process that cost $100,000 and has a ten-year life. With tariff protection, the machine will earn a profit of $7,500 per year. With current Canadian tax law, the company's books will reflect this particular transaction as follows:

funds raised on foreign capital markets. As long as the existing subsidiaries remain in Canada, they would provide their own internally generated funds for this new investment. Since the location of new U.S. firms in Canada would no longer be a major source of investment funds, we do not need to worry about any disincentives to such new direct investment that might be provided by a CAFTA.

- Multinationals that remained in Canada would have two ways in which to serve the international market. They could rationalize, either in the form of world production mandates or in the form of world product mandates. In both of these cases, production would be rationalized in order to realize economies of specialization. The primary distinction is that with world production mandates, R&D, marketing, and other head office functions would be removed from the Canadian branch and centralized at the foreign head office. Under a world product mandate, however, the Canadian subsidiary would be assigned total responsibility for a certain product, or group of products, including the necessary R&D, marketing, and other related functions.

There is a tendency, particularly on the part of political observers, to accuse multinationals of making political decisions on these two al-

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	Actual depreciation (1)	*Profit* (2)	*Net cash flow* (3= 1+2)	*Depreciation for tax* (4)	*Tax paid at 46 percent* (5= .46 (3−4)
Year 1	$10,000	7,500	17,500	25,000	−3,450
Year 2	10,000	7,500	17,500	50,000	−14,950
Year 3	10,000	7,500	17,500	25,000	−3,450
Year 4	10,000	7,500	17,500	nil	+8,050

The company's tax liability with respect to this transaction is the net cash flow it produces (column 3) minus the allowable depreciation (column 4). The tax liability is negative for the first three years and is useful on the assumption that this amount can be used to offset positive net revenues produced by other levels of activity.

Now suppose at Year 5 that tariffs are reduced and that the operation now becomes less competitive. Suppose, for example, that profit is eliminated and revenues from the operation just cover depreciation. Now let the company consider running its investment down to zero. For the next five years, it will have to pay tax on the $10,000 of gross revenue that really is depreciation. But if the company decides to stay in Canada, it can invest the $10,000 in new capital and avoid tax altogether for the first four years of the new investment. See J. Murray, "The Tax Sensitivity of U.S. Direct Investment in Canadian Manufacturing," *Journal of International Money and Finance* 1 (1982): 227–240; and D. Brean, *International Issues in Taxation: The Canadian Perspective*, (Toronto: Canadian Tax Foundation, 1984), p. 88.

ternatives — that is, they are alleged to prefer the option that keeps the basic research and so on at home. The evidence suggests, however, that, as in most matters, firms are more concerned with profitability than with political issues, and they thus choose the option that is most economic. For older products produced by a standardized technology, efficiency and cost control are key factors, and scale economies in R&D and administration are best achieved by world production mandating. For newer products, where dynamism and innovation are important, a more localized administration is beneficial, and there are substantial benefits to close contact between marketing, production, and research. If, in addition, the R&D is of a type that can be decentralized, then world product mandating will be feasible and will often be preferred.[19] The fact that different branches of single multinationals have been observed to use both product and production mandating suggests that these decisions are driven more by considerations of profitability than nationalism.[20] These considerations suggest that not all multinational branches and subsidiaries in Canada would be closed. Instead, some would get world production mandates while others would get world product mandates.

Head Office Concerns

Our fourth point concerns head offices. The Economic Council of Canada has expressed the view that many Canadian head offices of foreign subsidiaries would be consolidated with parent head offices. Bilateral trade liberalization is, however, a two-way street: the removal of U.S. tariffs would permit Canadian and overseas investors to service all of North America from within Canada and some would no doubt elect to do so. On balance, however, the Canadian economy could lose from the net effect of these head office movements.

The Significance of Comparative Advantage

Our fifth point follows from the point originally made in Chapter 2: that trade depends on comparative, not absolute, advantage. The exchange rate adjusts the real terms of trade so that, over the long term, and on average, the current account balances. (Or to be more precise, any long-

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[19] B. Wolf, "World Product Mandates and Freer Canada-United States Trade," in A.M. Rugman, ed., *Multinationals and Technology Transfer: The Canadian Experience* (New York: Praeger, 1983), pp. 91–107.

[20] H. Crookell, "Specialization and International Competitiveness," *Business Quarterly* 49 (Fall 1984): 28.

term imbalance is only equal to desired long-term net capital flows.) If it turned out that the levels of all Canadian industrial costs were so high that Canadian firms could not export to the United States, our inability to export, plus the outflow of capital that would then ensue, would push down the value of the Canadian dollar on the foreign exchange market until Canada was once again able to export successfully. This adjustment mechanism is potentially very powerful. If, for example, Canada had trouble exporting after the introduction of a CAFTA, there would be modest downward pressure on the Canadian exchange rate. So Canadians need not worry about being deindustrialized by a CAFTA because the exchange rate would adjust to ensure that our very large manufacturing sector was able to export enough to bring Canadian international payments into balance.

Thus, it seems very unlikely that a continuation of the trade liberalizing policies to which Canada has successfully adjusted over the last decades would suddenly cause a capital outflow due to the inability of Canadian products to compete internationally. If this "disaster scenario" did unaccountably come to pass, however, the exchange rate would adjust our terms of trade so that a balance between imports and exports would emerge.[21]

Evidence from Past Adjustments

Our sixth, and final, point is based on what we have already observed: trade liberalization has been going on for a long time so there is already considerable evidence about its effects on investment. Some branch plants and foreign subsidiaries did close down as trade was liberalized. These were plants that were originally attracted by the high tariffs established by the National Policy mainly to serve the protected Canadian market. This does not suggest that further trade liberalization would lead to an exit of multinationals. Rather, the evidence suggests that, while it would lead to the closing of productive capacity whose purpose was solely to serve the protected home market, other productive capacity would expand to meet the needs of a rationalized export market.

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[21] The deterioration in our terms of trade would preserve export markets and employment. It would, however, be accompanied by a decline in living standards, since more would have to be exported to pay for any given amount of imports. But the fall in living standards would not be the result of a CAFTA but would instead be the result of the fact that Canadian costs were much higher than costs in the rest of the world. In the end, living standards are influenced more by local output per head — that is, local productivity — than by any other single factor.

Wouldn't a CAFTA retard Canadian R&D as well as preventing Canada from adopting an industrial strategy that is needed to modernize the economy?

There has been much debate over the years about the behavior of foreign-owned firms in Canada, particularly with respect to their R&D expenditures. Fortunately, most of this debate can be ignored here because it is irrelevant to the issue of a CAFTA. We have argued that there is no reason to believe that a CAFTA would lead to a major increase in the amount of foreign ownership of Canadian-based industry. Insofar as there is any discouraging effect of foreign ownership on R&D expenditures, this undesirable effect would not be significantly increased as long as the CAFTA did not significantly increase foreign ownership. Indeed, since there are some reasons to expect Canadian ownership to increase, any retarding effects that foreign ownership might exert on R&D expenditures would be diminished by a CAFTA.

Leaving foreign ownership aside, the most straightforward effects of a CAFTA on R&D seem to be encouraging rather than discouraging. A CAFTA would bring with it a restructuring of industries and the exploitation of economies of scale and of longer production runs. Those head office functions that remain in Canada would be for operations serving the whole North American market, instead of just the small Canadian market. Where world product mandating did occur, the larger markets and revenues would provide the incentives and the resources for more R&D in Canada. So both the carrot of larger markets, and the stick of less protection, should provide some incentives for more Canadian R&D.

The question of R&D raises the broader issue of industrial strategy. We may wonder if the terms of a CAFTA would interfere with Canada's independence to operate any economic policy that is considered beneficial. Specifically, would the terms of a CAFTA interfere with any desirable Canadian industrial policy?

Once again, the key to this issue is in understanding the pre-CAFTA "base case". Right now, there is some real uncertainty about which of Canada's current subsidy policies would be countervailable. Subsidies that are "generally available" are not currently countervailable. One of the objects of a CAFTA would be to enshrine that rule, which is currently subject to possible erosion in the United States, in the conditions of the free trade agreement. Canada's ability to follow a "climate-style" industrial policy would then be *more* secure under a CAFTA than it is now.

A more detailed industrial policy, such as is envisioned in the inward-looking option two, might be more difficult to operate even under the present arrangements. Many of the specific policies that are envisioned might turn out to be countervailable. But this constraint on a policy of detailed and specific subsidies exists now, and there is no reason to believe that the conditions of a CAFTA would increase its severity. Indeed, if, as we recommend in the next chapter, a CAFTA agreement had the effect of reducing uncertainty about what is and is not subject to countervail, it might increase somewhat the scope for an "interventionist-style" industrial policy.

Wouldn't Canada have to harmonize its tax policies with those of the United States, with the result that it would lose its independence in tax and social policies?

The major worry that is expressed here concerns the relative incentives for capital and labor to locate in the United States, or in Canada, particularly as they are influenced by tax policy. Many worry that U.S. corporate tax laws that are more favorable to investment — for example, accelerated depreciation — would attract to the United States some capital that would otherwise have gone to Canada. Another worry is that because United States personal income tax laws are more lenient than those in Canada — for example, interest deductibility — management would prefer to live in the United States. They would thus be influenced, at the margin, to choose the United States rather than Canada as the location for new investment. In both of these cases, Canada's choice would be to accept the loss of capital that would otherwise locate there or to change Canadian tax law in the direction of U.S. law.

The Base Case

Once again it is important to be clear on the "base case". At present, the international mobility of capital, and to some extent of management, puts major constraints on the policy independence of all countries. The issue is not, therefore, whether there are constraints on the independence of Canadian tax policy. Rather, the issue is whether such independence as now exists would be seriously reduced by the formation of a CAFTA.

The close economic relationship between Canada and the United States that has always existed puts substantial limitations on Canadian policy independence on tax matters. Most experts seem to feel that going the whole way to a free trade area would not greatly reduce the limited in-

dependence that Canada now has. This is, however, a qualitative judgment and there is room for further study of, and argument about, this issue.

The Senate Committee on Foreign Affairs has noted that no need for complete harmonization has been felt in free trade areas — or even in the much closer associations of customs unions and common markets — that have existed elsewhere.[22] Also, significant policy differences persist even now among Canadian provinces and U.S. states. So the maintenance of some significant differences would seem to be possible.

Border Tax Adjustments

Some observers seem to believe, in spite of the general evidence cited above, that a free trade area would force a complete harmonization of tax policies on the two countries. Policymakers, for example, have often worried that differing degrees of national reliance on indirect and direct taxes provided countries with differential advantages in international trade. In particular, the European system of a value-added tax, with remission on goods exported, has been seen by some Americans as giving European goods an unfair advantage in international trade.

A justly famous article, written in 1970 by Mel Krauss and the late Harry Johnson, showed the fallacy of this belief.[23] General taxes, such as the European value-added tax, that are remitted on goods crossing the border, or general subsidies on all exports, do not affect the long-term international competitiveness of different countries' goods. The contrary belief comes from ignoring the long-term influence of the exchange rate in equilibrating the flows of international payments. (See our discussion of this in Chapter 2.) Anything that appears to give all of one country's exports a generalized advantage — or disadvantage — will cause an offsetting movement in the exchange rate. For this reason, the belief that all tax systems must be made identical if countries are to trade on an equal footing is incorrect.[24]

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[22] Canada, Parliament, Senate, Standing Committee on Foreign Affairs, *Canada-United States Relations*, vol. 3, *Canada's Trade Relations with the United States* (Ottawa: Supply and Services Canada, March 1982).

[23] H. Johnson and M. Krauss, "Border Taxes, Border Tax Adjustments, Comparative Advantage, and the Balance of Payments," *Canadian Journal of Economics* 3 (November 1970): 595–602.

[24] For a discussion of the intricacies of the debate about border tax adjustments, see G. Hufbauer and J. Shelton, *Subsidies in International Trade* (Washington, D.C.: Institute for International Economics, 1984), pp. 51–56.

Tax Systems and International Trade

The general principle is that it will not matter for a country's competitive position in international trade whether the government raises all of its revenues from a broad-based indirect tax such as the value-added tax or from a broad-based direct tax such as the income tax. Of course, under either system, high taxes can blunt incentives.

Exemptions or other anomalies in either type of tax system can affect trade flows. For example, the Canadian manufacturers' sales tax applies only to goods, not services. As a result, demand for services is increased relative to demand for manufactured goods, thereby stimulating the expansion of the services sector.

Financing of Social Programs

One important application of this principle is in the financing of social programs. In Canada, medical care is largely financed from tax revenues, while in the United States, medical care is largely financed through private insurance. Industrialists in both countries have argued that the other country's system confers an advantage over their competitors! Canadian businessmen express concern that they have to pay taxes to finance the health care system, while their U.S. counterparts are not subject to the same taxes. At the same time, U.S. businessmen argue that health care in Canada is provided "free" by the government while they have to pay large health insurance payments in addition to wages and salaries to their employees. In practice, the differences in the financing of health care in Canada and the United States have little or no significant effect on the pattern or level of trade. The costs of health care are real, but a country's competitive position will not be seriously affected if these costs are paid out of gross business revenues before factors of production are paid, or out of factor incomes after these have been paid by firms.

Over the long haul, it does matter for an economy's international competitive position how many resources are devoted to public expenditures, whether national defense, education, social programs, public infrastructure, or the national debt. Each society establishes its own priorities for expenditures in these areas and must bear their cost. But these costs must be absorbed, regardless of whether there is more or less trade liberalization.

Migration Incentives

Economic analysis of international trade provides one general reason why the tax harmonization issue may not be quite as serious as it might otherwise seem. To see what is involved, two initial conditions need to be stated.

First, most Canadians are willing to remain in Canada even though their material living standards could be increased by moving to the United States. The larger the discrepancy between the living standards in the two countries, however, the greater the incentive to migrate to the country with the higher living standards. To illustrate what follows, assume that everyone now living in Canada is prepared to accept a differential of 15 percent as the cost of remaining Canadians, but that as the differential rises from 15 percent to 20 percent to 30 percent and so on, more and more people would prefer to migrate.

Second, it is well established that trade liberalization tends to reduce the international discrepancies between the earnings of similar factors in different countries. Thus, a further bout of Canadian-U.S. trade liberalization would tend to narrow the gap between the earnings that similar types of labor and management earned in the two countries.

The present gap in real after tax living standards available to skilled labor and management in the two countries is mainly the result of lower productivity in Canada, but some of it is the result of a higher effective level of personal income tax in Canada. (Against which must be set the higher level of public services, such as free medical and hospital care, that is provided in Canada.) If, by narrowing the productivity gap, a CAFTA narrowed earnings discrepancies, it would *increase* the degree of tax-policy independence. Say, for example, that the current earnings differential is about 10 percent, and that it narrowed to 8 percent as a result of a CAFTA. As a result, there would be room for *increased* intercountry differences in tax policies. Any new tax policy that widened the gap by two percentage points would only restore the status quo that existed before the CAFTA.

Conclusion

Let us summarize the three levels on which Canadian trade policy options have been debated.

The first level of debate concerns the balance of economic advantages and disadvantages among the policy options that we have enumerated. Should Canada stick with the status quo, choose the inward-looking op-

tion, or choose one of the trade-liberalizing options?

Many observers join us in finding the status-quo option unsatisfactory. This finding shifts the debate to the issue of whether to proceed to more trade liberalization, or to raise trade barriers and rely on a strong, interventionist, industrial strategy to make the Canadian economy competitive. We reject the inward-looking option, both because its chances of success seem small to us and the costs of its failure enormous. We, therefore, recommend trade liberalization. This leaves us with the choice between options three, four, and five. For the reasons outlined in Chapter 4, we believe that options three and four carry a high risk of providing "too little and too late." While we believe that Canada should continue to push hard for multilateral liberalization through the GATT and through any other means available, we feel that a bilateral initiative on trade liberalization with the United States is needed as well.

The second level of debate concerns the deep, general fears of social, political, and economic survival that were discussed in Chapters 6 and 7. On the one hand, these fears lead some people to advocate the inward-looking option. We believe, however, that this option would actually increase the chances of some of these fears being realized. On the other hand, many people who reject the inward-looking route still worry about pursuing the bilateral option because of these broad concerns, which lead them to accept the status quo or the multilateral option.

Although there must always be unsettled issues and uncertainties, our survey of these fears leaves us satisfied that most of them are overstated as far as a CAFTA is concerned. Basically, a CAFTA would only accelerate the liberalizing trends to which the economy has already been adjusting for two decades. Thus, we see no reason why the nature of the adjustment, or its political, social, and economic consequences, should be radically transformed by a CAFTA. Where there are serious worries, such as the loss of some freedom to maneuver on cultural policy, we believe that alternative policies could be devised in most cases. In those few where they could not, the erosion could probably be kept within reasonable bounds by bargaining for exemptions in the CAFTA agreement and by careful domestic planning.

The third level of the debate is what must now concern those who have come with our argument this far. We accept that change is needed; we accept that this change should be in the direction of trade liberalization that must have a specifically Canadian-U.S. component; we accept that the "grand fears" are not sufficient to justify temporizing. So what we should now be debating in Canada are the outlines, and sometimes the

precise details, of the trade liberalizating agreement that we would like to see concluded with the United States. What are the potentially advantageous features of such an agreement that we would like to promote? What are its potential risks that we should seek to avoid? In the next two chapters, we turn to this third set of issues.

8

The Negotiating Issues: What Should a CAFTA Include?

Bold changes are needed in Canada's economic policies. Freer trade between Canada and the United States would stimulate productivity growth in both economies, improve consumer choice, and enhance the international competitive position of both countries. Although the economic case for removing trade barriers between the two countries is strong, there are substantial risks and pitfalls as well. The priority for Canadians, and Americans as well, is now to engage in a debate about the objectives, outlines, and some of the precise details of the trade-liberalizing agreement we would like to see concluded with the United States. Negotiating a Canadian-American Free Trade Area (CAFTA) could pioneer new approaches to economic interdependence and would likely involve significant policy compromises by both countries.

This chapter focuses on these issues. We begin by considering the agreement's objective. We then examine questions about what the agreement should cover. Should it be bilateral or available to other nations? What industrial sectors and what economic activities should be included? Next, we study the central issue of negotiating limitations on the two countries' nontariff barriers (NTBs). Limiting the potential for excessive use of each country's contingent protection mechanisms poses difficult issues, since each country would wish to retain key elements of its antidumping and countervailing duty laws. Canadians are also particularly sensitive to the potential implications for Canadian resource policies, while U.S. interests have a continuing concern about Canadian investment policies.

The subsequent chapter deals with more detailed, but nonetheless important, problems of implementation and administration.

The Objective

Free trade areas can take a number of forms. Historically, many free trade areas have just covered tariffs while leaving NTBs largely untouched.[1] The European Common Market — in many ways wider in scope than any free trade area — does not control very effectively some NTBs such as standards and government procurement. In spite of such precedents, it would be highly desirable for Canada and the United States to conclude agreements covering of their entire battery of barriers to bilateral trade, including both tariffs and NTBs. Tariffs could be removed and the use of NTBs severly restricted.

To us, the most important principle is that the two countries should start with a presumption of full coverage of trade in goods and services, and then bargain where absolutely necessary about a limited number of exclusions. If one starts from a limited base and then bargains about inclusions, the political process is likely to keep the agreement too limited. This lies at the core of our concern that the sectoral and functional approaches to the bilateral option would not result in a major liberalization of trade: it is hard to gain agreement on the inclusion of any particular sector or instrument because each is looked at by each country for its balance of advantages. Stated in its simplest form, the scope of the agreement would be much broader if agreement was required to exclude any sector than if agreement was required to include it.

The same argument applies to the types of trade barriers to be included in a CAFTA. The two countries should start with the presumption that all forms of trade barriers should be removed, and then bargain about what forms might either be excluded altogether or else left in place, but with a scope that was limited by the agreement. If this were done, then a Canadian-American Free Trade Area would clearly meet the criteria of Article XXIV of the General Agreement on Tariffs and Trade (GATT) and thus reduce the potential objections from other trading partners.

So, subject to some considerations given below, we believe that the object should be to ensure security of access for substantially all of each country's goods and services to the other country's market on the basis of "national treatment". This means, again with some exceptions to be considered below, that the agreement should cover goods and services and that, as well as removing all tariffs, it should seek to restrain, and where possible eliminate, NTBs.

[1] An earlier proposal for a Canadian-U.S. free trade area focused on the removal of tariff barriers. See S. Lea, *A Canada-U.S. Free Trade Agreement: Survey of Possible Characteristics* (Washington, D.C.: Canadian-American Committee, 1963).

Coverage

These general goals raise questions, to which we must now turn, of the inclusiveness of the agreement. Will it be open to other countries? What goods might have to be excluded? Will services be included?

Availability to Other Nations

Two approaches are possible. First, a CAFTA could be a genuinely bilateral agreement between Canada and the United States and not open to any other country that might wish to enter it. Second, the agreement could be made available to other countries on a conditional most-favored nation (MFN) basis. In this case, any country that wished to accede to the rules of the CAFTA could become a member. One commentator has suggested that a CAFTA could eventually lead to a free trade area involving most or all countries that are members of the Organisation for Economic Co-operation and Development.[2] But realization of such a prospect would undoubtedly take decades rather than years.

The logic of the bilateral option, where the bilateral liberalizing of Canadian-U.S. trade is seen as a second-best alternative to multilateral liberalizing, would seem to call for the conditional MFN approach to the possibility of including other countries, remote as this prospect may be. There would then be no suggestion of an exclusive club. Any country that wished to allow the free entry of goods and services into its home market and abide by a host of agreements to limit or remove NTBs could gain access on the same terms to the Canadian and U.S. markets. In any case, we doubt that in the near future any other country would want full access to the free trade area with all its obligations as well as its rights.

If a third country did apply for admission, major problems would occur wherever the original agreement embodied a number of specific decisions on issues, such as NTBs, that represent delicate compromises between the perceived self-interests of Canada and the United States. Bringing in third countries might then prove difficult, and might require the renegotiation of many of the special terms of the agreement. One possibility would be to accept the question of conditional MFN status, in principle, at the outset of the CAFTA negotiations, but to keep in mind the problems this might create for the possible inclusion of third countries as the bargaining proceeded on specific issues.

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[2] G. Hufbauer, "The Next International Trade Negotiations — A Reagan Round?" *Looking Ahead* (National Planning Association) 7 (February 1985): 1–5.

Since many of the difficulties in extending access to a CAFTA would arise in the area of agreements with respect to NTBs, a different approach could be taken on NTBs than is taken on tariffs. Both countries could agree to grant tariff-free status to other countries that acceded to the free trade area, while reserving commitment on some of the NTB issues.

A much more likely prospect is that some key component of the bilateral agreements — which together constitute the free trade agreement — could be made available to other countries that accept the obligations embodied in that particular component. For example, trade in services is not presently covered under the GATT. An agreement between Canada and the United States to liberalize trade in key services sectors could be open to other countries that were also prepared to liberalize trade in those services.[3]

Regardless of whether other countries seek to join the free trade area or to participate in key component agreements, their potential inclusion in the agreement is an important negotiating consideration for the United States. In the words of the President's Council of Economic Advisers, such bilateral negotiations "tend to reverse the usual incentives in international trade negotiations by making countries more eager to be among the first to agree to liberalize trade rather than among the last."[4] Since each country would be free to negotiate lower tariffs in multilateral negotiations, there would be incentives for other countries to liberalize their trade even if they did not seek to join the free trade area.

Exclusions of Coverage

The second issue of coverage relates to bilateral trade in goods. If the presumption is to include all goods, what major possible exclusions might need to be negotiated?

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[3] An example of this type of option is the Frazee-Grey proposal to liberalize trade in computer services. See R. Frazee, *Trade and Technology: It's Canada's Move* (Montreal: Royal Bank of Canada, 1983); and R. de C. Grey, *Traded Computer Services: An Analysis of a Proposal for Canada/U.S.A. Agreement* (Montreal: Royal Bank of Canada, 1983).

[4] United States, Executive Office of the President, *Economic Report of the President, Transmitted to the Congress February 1985, together with the Annual Report of the Council of Economic Advisers* (Washington, D.C.: U.S. Government Printing Office, 1985), p. 125.

Agriculture

One source of pressures for exclusions might be the agricultural sector. Some agricultural industries, such as beef, might welcome free trade. Others are likely to resist it.

The biggest problems will arise with commodities subject to "supply management". Some government marketing boards, such as the Canadian Wheat Board, operate mainly as agencies for the orderly marketing of a particular product. No serious conflict should arise between their objectives and the normal rules of a free trade area. Serious problems would arise, however, with marketing boards that seek to regulate output and keep prices above what they would be on uncontrolled markets. Most of these boards operate at the provincial level, but with the support of concurrent federal legislation restricting imports. Since these arrangements would cause serious problems in any negotiations, a word or two needs to be said on the effect of this type of provincial marketing scheme.

Such schemes work by restricting output. This is done by issuing production quotas. The result is that average price levels and, hence, also average farm revenue levels, are higher than they would otherwise have been. The value of the extra profits becomes capitalized in the value of the quota, or whatever instrument is used to grant the right to produce and sell in the controlled market. (The quota itself may be salable, or it may be attached to a particular farm, in which case the farm itself may be sold.) For this reason, farmers who are new entrants to the industry in question earn only a normal return on their investment, because the excess return is capitalized in the price that must be paid for the quota.

The quota system also may keep farm prices high by keeping costs above what they would be in a free market. Insofar as the quotas prevent the growth of very large firms, they prevent the realization of the scale economies that have become available due to technological changes in agricultural production.

Notice that the quota does not make farmers any less open to difficulties when interest rates, or other costs, rise unexpectedly. Because the system increases the investment needed to become a farmer and leaves the return on that investment no more than normal, periods of unexpectedly high costs cause just as many difficulties to farmers as they would have if prices and revenues were at free market rates. Indeed, by increasing the captial outlay needed to become a farmer and, hence, necessitating more farm debt, they may leave farmers more exposed to the

consequences of unexpected cost increases such as occur when interest rates rise.

The big gainers from the quota system are those who were granted the quotas when the system was initially set up. All quota holders also gain to the extent that the demand for their product rises faster than the quota-restricted output is allowed to rise. The growing scarcity then raises output prices, and the resulting extra revenues get capitalized into an increasing value of the quota. The losers are consumers who pay more for the product than they would have if the market were uncontrolled.

Provincial marketing boards of the output-restricting type would run into difficulties under a CAFTA. Indeed, free trade with the United States in the products covered by the boards' activities would destroy the system. Wherever marketing boards were holding prices above their long-term, free-market levels, imports would be attracted and the prices available to local producers would fall.

There are two possible reactions to this end of the provincial marketing system. First, existing farmers could be left to suffer the loss in the value of their quotas. This would, no doubt, be regarded as inequitable, since farmers would have bought their quotas with the expectation that the existing system would continue indefinitely. Second, governments could buy out the quotas, thus taking on the capital loss involved in ending the system. Taxpayers, although footing the bill for ending the quota system, would be the long-term gainers because of lower food prices.

How much loss would be involved, either for the farmer if there was no compensation, or for taxpayers if there was compensation, is an important question. If the new system was introduced without a transition period, the loss would be the whole market value of the quota. But this is a very unlikely situation. Assuming that free trade in agriculture was phased in over a longish period by gradually increasing import quotas, the capital investment that farmers had in their production quotas would be eroded over that period. This would make the capital loss in the value of the quota something like half its current value.[5]

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[5] To illustrate, consider a simple example. Let the interest rate be 10 percent, and assume the government announces that free trade in agriculture is to be phased in over a ten-year period. The phasing in is to be made in such a way that the revenues farmers earned that were above the competitive rate would be eroded at 10 percentage points each year, starting in one year's time, and reaching zero in ten years' time. This would reduce the present value of the quota by about 50 percent. (The remaining value represents the value of the restrictions that persist, but with diminishing force, for the next ten years).

Phasing in free trade in agricultural goods, ending those activities of marketing boards that were designed to lower output and raise prices, and paying compensation to farmers for the losses that they would suffer — about one-half the current market value of their quotas — would be a potentially feasible solution. There would very probably be an outcry, however, from those who benefit from the present quota system. These are farmers who get a more secure market for their production, and an accretion in quota value as demand rises over time faster than the quota-restricted supply is allowed to rise.

As part of the policy to phase out the farm quota system, the import quotas could be replaced with tariffs that were estimated to provide the equivalent protection to Canadian farmers. The tariffs would then be phased out on a timetable agreed to during the CAFTA negotiations. This is, in principle, not very different from phasing out the import quota system, but it might be administratively easier to operate. The issue of compensation would still arise, because any new system that included tariffs and their phasing out within no more than a decade would entail a capital loss to current quota holders.

The alternative at the opposite end of the spectrum would be to exempt specified agricultural commodites from a CAFTA, and allow the provincial marketing boards to continue to hold Canadian farm prices substantially above what they would be in uncontrolled markets. The worry is that Canada would then be doing just what the European Community did with its Common Agricultural Policy: laying down a series of time bombs bound to explode in bursts of increasing troubles, decades down the line. If the economic size of farms continues to grow, provincial policies might serve to protect a farm structure becoming progressively more and more uncompetitive. Over time, U.S. food prices would fall relative to Canadian prices, and manufacturing industries that use agricultural products as inputs would migrate to the United States. This would put increasing pressure on the Canadian support system. Suitable reform at suitable times might prevent collapse, but the pressure on the system would be continuous. Also, the conspicuous exemption of agriculture from a CAFTA, with consequent higher food costs in Canada compared with those in the United States, would reduce the real income of Canadian consumers.

Industries under Pressure

Highly protected industries, such as clothing and textiles, might press for exemption under a CAFTA. There are, however, good reasons to

include such industries. Their inclusion would force them to rationalize in ways that protection would not. As a result, both countries' industries would find particular niches where they could survive and serve the whole North American market. Their products would tend to be pushed "up market", which, as we saw in Chapter 2, is one of the major objectives of trade liberalization. No doubt, some firms would fail and some of the more high-cost industries would contract. But the contraction would be in those parts of the industries where long-term competition from the low-income developing countries is inevitable, and where, sooner or later, Canada must eliminate its production if it wishes to be a high-income, high-value-added producer. The longer this adjustment is postponed, the more difficult it will be when adjustment comes, as come it must. Indeed, there would be less upheaval if the inevitable adjustment is made in the context of an emerging CAFTA in which the expansion of other sectors would provide new jobs. Although the Textile and Clothing Board report is sometimes cited as evidence of the adjustment pressures of freer trade, the discussion in Chapter 7 indicates some of the substantial opportunities to rationalize production and improve productivity that would flow from freer bilateral trade.

No doubt there are other candidates for omission, such as shipbuilding, and each would have to be considered on its merits, but on the assumption that every industry would be in unless there was a very good case for exclusion.

Services

We now come to one of the most important issues of coverage. The typical free trade area covers all goods, except those that are specifically exempted. We would argue that a CAFTA should also cover most services.[6]

Traditionally, goods have been regarded as the most important items of national production and of international trade. Only recently has the growing importance of services in the GNP and in trade led to detailed studies of their peculiar problems. As a result, there is still relatively little detailed analysis of services, either empirically or theoretically. Exactly what is a service? Is trade in services governed by the same economic principles as trade in goods? How is international trade in services

[6] This section draws on W. Diebold, Jr. and H. Stalson, "Negotiating Issues in International Services Transactions," in W.R. Cline, ed., *Trade Policy in the 1980s* (Washington, D.C.: Institute for International Economics, 1983): 581–609; as well as on Frazee, *Trade and Technology;* and Grey, *Traded Computer Services*.

restricted, and how can it be liberalized? What do we mean by free trade in services? These are some of the questions that are still being debated. As a result, we must expect negotiations for Canadian-U.S. trade liberalization in services to travel through territory that is largely uncharted — although a few important signposts have been placed along the way by such studies as the proposal for an agreement on trade in computer services.[7]

The Concept of a Service

Let us first ask, What is a service? One broad definition was given in legislation placed before the U.S. Senate in 1982. This defined services as,

> economic outputs which are not tangible goods or structures, and they include, but are not limited to, transportation, communications, retail and wholesale trade, advertising, construction, design and engineering, utilities, finance, insurance, real estate, professional services, entertainment, and tourism, as well as the overseas investments which are necessary for the export and sale of these services.[8]

Some services, particularly in the retail sector, are not traded internationally.[9] Many others, such as insurance and banking, are, however. The importance of services in the international trade of Canada and the United States can be seen by expressing their receipts for the sale of services abroad as a proportion of their receipts for merchandise exports.[10] In 1983, this was 13 percent of bilateral merchandise exports for Canada and 30 percent for the United States.

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[7] Frazee, *Trade and Technology;* and Grey, *Traded Computer Services.*

[8] Diebold and Stalson, "Negotiating Issues in International Services Transactions," p. 584.

[9] The extent of the nontraded services sector should not, however, be overestimated: the enormous international tourist industry implies that restaurant meals and dozens of other "local" services are traded, but by virtue of the foreign consumer coming to the commodity, rather than, as with goods, the commodity going to the foreign consumer.

[10] The balance of payments statistics show two major items on service account. The first is the payment of interest and dividends, which depends on a country's asset position. The rest is "other services", which are current payments for the receipt of such currently supplied services as shipping, insurance, and tourism. The data in the text refer to the "other services" account.

Barriers to Trade in Services

Currently, international transactions in services are subject to many kinds of barriers. Some are obvious, others are very difficult to document and, hence, to control. Here are a few of the ways in which barriers are erected against trade in services.

One of the most important is government procurement procedures, where preferences are often given to local providers of services — and commodities as well. These are discussed later in this chapter, so we say nothing more about them at this point. There are many administrative barriers and informal procedures that are applied differently to domestic and to foreign firms. Their existence, however, can be very difficult to prove. Foreign banks and insurance companies, for example, are often limited in the kinds of deposits they can take in, and in the kinds of policies they can issue. Furthermore, there are often ownership restrictions holding the market shares of foreign-owned service firms below what they would otherwise be. Foreign airlines often receive discriminatory treatment on everything ranging from landing rights to terminal facilities and baggage handling. Professionals sometimes find that they cannot practice unless they gain admission to local professional associations, which then turns out to be almost impossible to obtain. Data-processing firms sometimes find it hard to make computer time-sharing arrangements unless the data are processed locally. And so it goes, through a host of overt and covert restrictions.

In many cases, regulatory practices restrict competition unduly. This is a more serious problem on the Canadian side of the border, where deregulation has not gone nearly so far as it has in the United States. Canadian trucking and financial services regulation are cases in point. It can be argued that most of these restrictions on competition benefit few except the local producers. Consumers in general, and users of the services in particular, would be better off if these practices were ended. So there is little reason to try to exclude these sectors from the general presumption of free trade in services — although quite naturally there would be an outcry from those who would lose their presently protected positions.

Importance of Services to the United States

Services are particularly important for any CAFTA negotiations because the United States is extremely interested in liberalizing world trade in these sectors. Although barriers to trade in services are hard to meas-

ure, many U.S. firms that provide services in foreign markets feel that the barriers they face tend to rise more or less in proportion to the success that they have in penetrating these markets. For this reason, the United States is extremely interested in establishing codes for the treatment of services, and if the United States has any say in the matter, the next round of GATT negotiations will address the services issues.

The U.S. administration would attach great importance to any agreement on the liberalization of trade in services that can be incorporated in a CAFTA. The United States would like to demonstrate to the rest of the world that such agreements are possible. It would also like such an agreement to be satisfactory enough to provide a model for multilateral negotiations within the GATT, or in other bilateral negotiations should the GATT fail to make significant headway on this matter in its next negotiating round.

This makes liberalization of trade in services an important bargaining chip for Canada. Canadians should, in any case, gain from such liberalization, but Canada's willingness to negotiate on these matters and to make significant concessions would be a chip of real value in getting more of what we would want in other aspects of the negotiations.

The U.S. interest also ensures that the services lobby in the United States will be a key part of the coalition in favor of accepting any trade-liberalizing agreement that the two countries negotiate. Such a coalition is needed to obtain the necessary congressional approval. By being as flexible and as helpful as possible in the area of services, Canada would secure an important ally in the U.S. services lobby, as well as gaining points with the U.S. administration.

Liberalization of Trade in Services

What, then, could be done to include liberalization of trade in services as part of a CAFTA?

Certain restrictions, such as licensing and fee requirements, that are imposed differentially could be treated like tariffs and any foreign differentials removed.

More often, however, the restrictions on services would not be so simple. In these cases, the analogy would be closer to NTBs than to tariffs. This suggests that the approach to reducing trade barriers in services might be similar to that of negotiating on NTBs. There is some experience on this arising from the Tokyo Round of GATT negotiations. Using this analogy, Diebold and Stalson suggest that bargaining might take place in two ways:

> First, there will be the negotiations about the rules exceptions, and related matters....The codes [will be] a combination of agreed rules with regard to certain kinds of practices (or their prohibition) and a rather elaborate set of arrangements whereby other practices (such as subsidies) are treated as sometimes legitimate and sometimes illegitimate depending on a variety of circumstances.[11]

Secondly, according to these authors, there would be bargaining about the interpretation and application of these rules, and about what could be done before a dispute-settlement mechanism was put into motion.[12]

It would appear that by taking the following steps, a great deal could be done to liberalize Canadian-U.S. trade in services:

- Each country should grant the other national treatment in the services sector with a list of negotiated, and carefully specified, exceptions. (Some of these are considered below.)
- This treatment should be extended to others on a conditional MFN principle. This means that third countries prepared to extend national treatment to Canadian and U.S. services in their own markets would be able to enter the agreement. Note that this offer could be separated from the offer to admit countries to the whole CAFTA agreement on a conditional MFN basis. The latter offer seems unlikely to be taken up. But other countries might well find attractive the offer to admit them to the narrower services agreement.
- A dispute-settlement mechanism could be set up, whereby sellers of services who feel that they are not getting national treatment in the other's market could have their complaints heard and arbitrated. This might provide a check on some of the more covert practices that observers other than those actually affected would find hard to identify.

Right of Establishment

One of the most difficult issues would concern the right of establishment. Barriers to trade in services are interrelated with barriers to investment, because a physical presence in the country is often necessary if the service is to be sold there — for example, the supply of U.S. banking services in Canada requires that a U.S. branch bank be set up in Canada. Considerations of national interest, and of cultural support, make

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[11] Diebold and Stalson, "Negotiating Issues in International Services Transactions," p. 590.
[12] Ibid.

countries unwilling to grant unrestricted right of establishment to foreign-owned companies in what are regarded as sensitive sectors.

One way to handle this issue is to accept the general right of establishment within a CAFTA, and then negotiate lists of acceptable restrictions as part of the agreement. Both countries would probably wish, for example, to prohibit foreign-owned radio stations, and Canada might want to place some restrictions on the entry of U.S.-owned banks and other financial institutions. In these sensitive areas, present practices would provide the national "base case". This means that the lists would start by institutionalizing existing practices, and then negotiations would liberalize, or further restrict, the right of access from this base. The important principle — that everything not otherwise specified would be granted the general free access that is ensured by the CAFTA — should be maintained, even though negotiations would start on the assumption that there will be more exclusions in this area than in many others.

State and Provincial Regulations

A further issue arises because many services are regulated by U.S. state and Canadian provincial governments, rather than by the two federal governments. There would be difficult issues here, and further exceptions might be necessary because of differences in the assignment of jurisdiction in the two federal states, rather than any principles of economic or political self-interest.

Once again, this is a more serious problem in Canada than in the United States. The federal commerce power gives the U.S. federal government the ability to determine most of the regulatory measures that might be used in restraint of international trade. Canadian courts, however, have interpreted federal powers less widely than have their U.S. counterparts. The Canadian provinces have exclusive jurisdiction over "property and civil rights", which provides the legal basis for much of the regulation of services.

The Canadian federal government does, however, have jurisdiction over important components of the services sector. In some cases, such as interprovincial trucking, the federal government has delegated that power to the provinces who have jurisdiction over intraprovincial trucking. In these cases, at least, there would be a lever for enforcing international agreements: if the provinces failed to fall in line with negotiated practices, the federal government could take back the authority that is provided to it constitutionally. Some service sectors such as banking, communications, and airlines do fall currently under federal jurisdic-

tion in Canada.

The differences in the constitutional systems of Canada and the United States raise difficult problems in negotiation about services — as well as on other NTB issues such as government procurement discussed below. One option is to exclude those practices falling under provincial jurisdiction in Canada from the scope of the agreement. Another option would be to develop mechanisms for provincial participation in, and the subsequent enforcement of, international economic agreements. This latter approach is explored by one of the authors in a forthcoming paper prepared for the Ontario Economic Council.[13]

Exemption of Cultural Services

As was discussed in Chapter 6, preservation of cultural activities is an important objective for many Canadians. One option would be to exclude culturally sensitive services from coverage in the agreement. This approach seems appropriate on the issue of right of establishment. Important issues would remain, however, in defining the scope of a cultural exemption.

Even in culturally sensitive areas, there could be mutual agreement about the types of policies that governments would use to achieve desired objectives. For example, Canada might agree not to apply some of the more discriminatory practices such as the Bill C-58 tax provisions for television advertising, while being permitted to subsidize cultural activities. This type of policy change would be welcomed by the United States and could have advantages for Canada. In particular, it might limit bilateral problems that could arise from actions under U.S. trade law against a foreign practice that is "discriminatory and burdens or restricts United States commerce."[14]

Rules of Origin

A final issue of coverage is where to draw the line between imports into a CAFTA and locally made goods. Since, in a free trade area, Canada and the United States would maintain their own separate external barriers to trade with other countries, it would be necessary to retain the use

[13] M. Smith and D. Steger, "Canada's Constitutional Quandary: The Federal-Provincial Dimension in International Economic Agreements" (paper presented at the Ontario Economic Council Conference, *Canadian Trade at a Crossroads: Options for New International Agreements*, Toronto, April 16–17, 1985).

[14] Section 301 (a) of the U.S. *Trade Act of 1974*, as amended by Section 304(b) of the U.S. *Trade and Tariff Act of 1984*.

of customs points between the two countries. Even with complete free trade between the two, there would be incentives for producers in other countries to route their exports through the member country with the lowest tariff — or with the least nontariff impediments — on that particular commodity. In order to qualify for duty-free bilateral trade, a commodity should either meet the criteria of duty-free entry into both countries or achieve an acceptable level of value added in both countries.[15]

From an administrative point of view, both countries could maintain their own antidumping and countervailing-duty systems. Although we recommend below that the bilateral application of countervailing and antidumping duties should be limited in important ways, either country could levy such duties if the other did not. The administrative procedure that would prevent these laws from being circumvented by arbitrage between the two markets would be the same as that used to cope with different external tariffs. It seems to us, therefore, that Canada and the United States would have to harmonize neither their external countervail and antidumping policies nor their internal laws on price discrimination.

Nontariff Barriers

A free trade area could be confined to tariff barriers only. We have already argued, however, that one of Canada's great advantages from a CAFTA would be in getting some limitations on the application of U.S. NTBs to our exports. Among potential NTBs that we consider here are government procurement, countervailing and antidumping duties, temporary import relief, and balance of payments measures. The first of these, government procurement, is a permanent trade barrier. The rest of these practices fall under the classification of "contingent protection" mechanisms. Countervailing and antidumping duties are intended to promote fair trade, but they can have protectionist effects. Temporary import relief and balance of payments controls are "emergency" measures that are presumed to be temporary but that can disrupt trade and influence investment decisions.

Negotiation about nontariff barriers is often difficult. There are likely to be particular difficulties in negotiating about contingent protection mechanisms. Both countries are likely to wish to retain key elements of their system of countervailing and antidumping duties. For example,

[15] For example, the Stockholm Convention that created the European Free Trade Association applied three different criteria to determining rules of origin.

in its negotiation of a free trade area with Israel, the United States refused to alter its trade legislation that is the basis for antidumping, countervail and other contingent protection mechanisms.

Nonetheless, there are anomalies in the application of these regulatory systems that could create problems in a Canadian-U.S. trade arrangement because of the close proximity of, and high degree of interdependence between, the two countries. Agreements confining and limiting the application of contingent protection mechanisms, would provide greater certainty for trade and investment decisions.

Canada has the greater interest in securing access to the much larger U.S. market. Thus, containing potential abuse or misuse of contingent protection mechanisms is an important objective for Canada. In order to obtain agreement from the United States on these issues, Canada could offer commitments to national treatment of investment and services, as well as the reduction of higher Canadian tariffs. The commitments on contingent protection would be symmetric, however. Canada would have to restrict the application of its import regulatory measures in the same way the United States does.

Procurement

The most significant permanent U.S. NTB that affects Canadian exports consists of government procurement preferences. These are exempt from the GATT obligation for governments to accord national treatment to each other as they must do on policies such as sales taxes. The federal governments of both countries agreed during the Tokyo Round to bring most of their direct civilian purchases under the obligations of the procurement code. But important components of government purchases in both countries, such as cost-shared programs, are not subject to the Tokyo Round commitments.

U.S. Procurement Practices

At the federal level, U.S. procurement preferences go back at least to the New Deal's "Buy America" act. However, there has been a proliferation of such policies at the state level in recent years — just as there has been in Canada at the provincial level. Among the most prominent of U.S. procurement preferences is the federally financed *Surface Transportation Assistance Act of 1982*.

Procurement polices are preferences, not prohibitions. Foreign suppliers must undercut home suppliers by stated percentages in order to

get any given contract. (The percentages themselves vary with several local conditions.) In these cases, a home supplier usually means a certain percentage — often 51 percent — of U.S. content in the product in question.

The Effect on Canada

The long-term effect of these policies has been to induce some Canadian firms to invest in the United States, or to buy U.S.-made components, in order to qualify as local producers. For example, Bombardier has established a plant in Vermont to assemble subway cars. Also, some of Northern Telecom's investments in the United States may be at least partly motivated by the need to satisfy state procurement laws.

Three arguments have been advanced to support the view that Canadian efforts to reform U.S. procurement practices should not be a high priority. First, the damage has already been done in terms of the emigration of productive facilities to the United States to meet U.S. procurement requirements and, once set up there, these facilities are unlikely to be returned to Canada. Second, the pressure to reduce government deficits will make government procurement less important in the future than it now is. Third, the switch in the pattern of U.S. federal expenditure from civilian to military purposes means that more U.S. procurement comes under the Defense Production Sharing Agreement, under which Canadian firms can supply the Pentagon on a nondiscriminatory basis.

Against these arguments is to be set the need to replace quite soon enormous amounts of decaying U.S. social capital such as urban roads, bridges, and public buildings. The probable irreversibility of decisions by Canadian firms to locate in the United States lends urgency to the need to deal with the procurement issue before further Canadian firms are drawn to the United States for no other reason than to get around local procurement preferences.

The Canadian Bargaining Position

Our initial bargaining position for a CAFTA, then, would be full national treatment on procurement matters. But would the U.S. government agree to end, or even significantly reduce, its procurement preferences?

In some cases, there are powerful consumer interests at work in favor of Canadian suppliers. For example, the attempt to exclude Canadian cement suppliers from the U.S. market under the *Surface Transporta-*

tion Assistance Act of 1982 met powerful resistance from U.S. border states and, as a result, the legislation was rescinded. In other cases, no such constituency exists. The attempt, for example, to liberalize trade in urban transit equipment as part of the sectoral free trade initiative failed because of congressional resistance. So long as the initiatives are piecemeal, substantial reductions in U.S. discriminatory procurement practices seem unlikely.

The difficulty of handling the procurement issue on a piecemeal basis is one of the attractions of an inclusive CAFTA approach. It might be possible to accomplish, through a blanket deal, what would not be agreed to as a single negotiated item. As part of a general CAFTA agreement, acceptance of the principle of national treatment for procurement would not be an impossible objective. It certainly would be one worth pushing for.

State Procurement Practices

One further major obstacle to achieving the national treatment objective is that so much procurement is done by the individual states, which have proliferated preferential procurement in recent years. The question then arises whether or not it would be constitutionally possible, and politically realistic, for the U.S. federal government to attempt to mandate the principle of national treatment for procurement on the state governments.

Constitutionally, a treaty duly negotiated by the administration and approved by the Senate could do this. Politically, such an apparently high-handed dismissal of the state governments' desires seems unlikely. There is, however, one major opportunity that might not be unimportant. Much of Canada's procurement difficulties in the U.S. market arise from the *Surface Transportation Assistance Act of 1982*. This is a federal-state cost-sharing program that is 80 percent federally funded. Here, the U.S. federal government's wishes should be paramount because it carries the bulk of the financial burden. In the case of procurements under this act, it might be politically possible to negotiate a treaty obligation requiring national treatment by federal and state governments for Canadian bids and replacing the present "Buy America" commitment. The U.S. federal government has a clear constitutional prerogative on international trade.[16]

[16] See J.H. Jackson, J.-V. Louis, and M. Matsushita, *Implementing the Tokyo Round: National Constitutions and International Economic Rules* (Ann Arbor: University of Michigan Press, 1984).

The Canadian Situation

So much for the U.S. situation. What are the chances of Canadian federal and provincial governments' agreeing to national treatment of procurement? So far, we have said nothing about discrimination in the procurement policies of these governments. Such policies abound at the provincial level. Newfoundland, New Brunswick, Nova Scotia, Quebec, and British Columbia discriminate across the board in procurement matters in favor of local bids. Despite disclaimers, Ontario allegedly has discriminated in favor of local suppliers of transportation equipment. The federal government should find it possible to negotiate a bilateral national treatment on procurement. With a bigger market for Canadian firms to tap in the United States than for U.S. firms to tap in Canada, and with Canada's apparent comparative advantage in such commodities as transportation equipment, there is likely to be a net gain for Canadian-based firms. This should provide a potent inducement for Canadian provincial governments to participate in a bilateral commitment on procurement policies. (The constitutional position of the Canadian federal government is much more ambiguous than its U.S. counterpart.)

If Canada as a whole gains, then, on balance, the provinces must gain. But many provinces are attached to their local preferences, and they may be hard to budge on this matter. In the national interest, a determined attempt should be made to do so. If that fails, then the next best position would be for the two federal governments to agree to national treatment in the projects where they are the principal suppliers of funds and to undertake "best efforts" with respect to provincial and state procurement. The purpose of this latter condition would be to contain discriminatory procurement practices at their present level. With rising protectionist sentiments on both sides of the border, that might not be an inconsiderable contribution.

Countervailing Duties

Under countervail, a country can levy duties on an import to offset subsidies received by the foreign exporter from its own government. In principle, therefore, countervail is a protection against "unfair" competition arising from government subsidization of the production of goods that are subsequently exported. It protects domestic producers against "unfair", government-subsidized, foreign competition. However, if it is "aggressively applied", it can become a potent barrier to trade. By aggressive application, we mean using countervail where there is no

differential advantage conferred by foreign subsidies. One example is interpreting as subsidies things that really are not subsidies. Other important examples will be discussed later in this section.

U.S. Practices

U.S. countervail law is such a potentially important force affecting the investment decisions of firms in Canada, and the policies of Canadian governments, that it is worth briefly reviewing the evolution of the U.S. law and regulatory process.[17]

The U.S. law imposing countervailing duties dates from the 1890s. The law was rigorously applied in the 1920s and 1930s. After World War II, however, the executive branch of the U.S. government decided to interpret the law very narrowly. Countervailing duties were imposed only when foreign governments paid explicit export subsidies; domestic subsidies were not considered.

When the GATT was formed, countervailing procedures were allowed for in the internationally agreed rules, but only on three conditions: if the offending import received a government subsidy; if the reduction in price and volume of subsidized imports was sufficient to do significant damage to the firms in the importing country (the so-called "injury test"); and if the subsidies "caused" the injury. Since the U.S. law predated the GATT agreement, the United States was able to claim "grandfather" rights, and so did not need to apply the injury test. The U.S. law, however, applied only to dutiable goods; countervailing duties were not applied to goods that normally entered the United States duty free.

During the late 1960s, the competitive position of the United States deteriorated under the impact of rising U.S. inflation in a regime of fixed exchange rates. As a result, Congress pressured the executive branch to interpret much more widely the conditions that would call for countervailing duties. This change had a major impact on Canada, when, in the Michelin tire case, Canada's regional development grants were found to be countervailable subsidies. More recently, in the softwood lumber

[17] This review of U.S. countervail law draws on S.D. Metzger, *Lowering Nontariff Barriers: U.S. Law, Practice, and Negotiating Objectives* (Washington, D.C.: Brookings Institution, 1974); R. de C. Grey, *Trade Policies in the 1980s: An Agenda for Canadian-U.S. Relations*, Policy Commentary no. 3 (Montreal: C.D. Howe Institute, 1981); G.C. Hufbauer and J.S. Erb, *Subsidies in International Trade* (Washington, D.C.: Institute for International Economics, 1984); and unpublished papers by G. Horlick, J. Bello, and D. Steger.

case, Canadian regional policies again have been found to give potentially countervailable subsidies. These U.S. precedents for countervail have potentially very serious consequences for exports from low-income regions in Canada.

The political pressures for more comprehensive enforcement of U.S. countervail law substantially influenced the very important *Trade Act of 1974*. In that act, Congress limited the discretion of the executive branch in ways that greatly increased the chances that countervail would be used. In particular, mandatory investigations could be initiated by complaints coming from the private sector. Countervailing duties were also extended to goods entering the United States duty free. But, since this was a new law, the United States could not claim a grandfather exemption, so the GATT injury test had to be applied to such goods.

For reasons associated with the bargaining at the Tokyo Round of GATT negotiations, the new countervail laws were not actually applied to Canada until the Tokyo Round agreements were implemented in the *Trade Agreements Act of 1979*. At that time, the law was amended to introduce the injury provision to dutiable, as well as nondutiable, goods. More importantly, a wide range of domestic policies of foreign governments were now deemed to be subsidies. For example, equity infusions into state-owned corporations were to be regarded as subsidies if the rate of return fell below risk-adjusted commercial rates of return.[18]

According to the current interpretation of the U.S. law, only foreign subsidies that are "specific to an industry or group of industries" are countervailable, while subsidies generally available across the whole economy are not. For example, tax credits for research and development that are available to all Canadian-based firms are not countervailable, but Canada's special regional investment tax credit is. This is some consolation to the federal government, which makes heavy use of subsidies as instruments of national policy. A recent court decision, however, has raised concerns that this principle may be eroded, so that even generally available subsidies might become countervailable.[19]

In 1983, the U.S. Department of Commerce ruled that Canadian exports of softwood lumber and other related products were not counter-

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[18] See United States, International Trade Administration, "Certain Steel Products from Belgium," *Federal Register* September 7, 1982, p. 39316; and idem, "Subsidies Appendix to Cold-Rolled Carbon Steel Products from Argentina," *Federal Register* April 26, 1984, pp. 18016–18023.

[19] U.S. Court of International Trade, in *Bethlehem Steel v. United States and Highveld Vanadium* (1984).

vailable, first, because the allegation of stumpage subsidies was rejected on the general availability — or "specificity" — criteria, and, second, because the total of potentially countervailable subsidies was less than .5 percent. However, future countervail actions against other Canadian products may well be successful. For example, the Commerce Department is currently investigating Canadian subsidies to hog and pork producers. In its preliminary determination, the department ruled that Canadian subsidies amounted to about 10 percent of the selling price. Consequently, a preliminary duty of 5.3 per pound is being imposed.[20] (This, in spite of the fact that the Congressional Budget Office has recommended Canada's farm income stabilization program as a less costly alternative to U.S. price supports.)[21]

Implications for Canada

It is clear that U.S. countervail has become a potent weapon that must seriously concern all trading countries. As we have already observed, however, the implications for Canada are more serious than for most other countries. There are three important reasons for this, two relating to trade and one to investment: the substantial dependence of Canadian exports on the U.S. market; the extensive use of subsidies as instruments of Canadian national policy; and the asymmetry between the effect of countervail applied by either country on products imported from the other.

The first two of these reasons relate to trade flows. Because subsidies are such a commonly used policy tool in Canada, Canadian products are particularly liable to countervail threats. Because trade is such an important part of the Canadian GNP, the application of countervail to Canadian exports can have serious consequences for Canadian standards of living.

The third reason relates to investment. As we observed earlier, firms supplying the North American market find countervail a much more serious threat if they are located in Canada than if they are located in the United States. A Canadian-based firm tends to export the majority of

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[20] International Trade Administration, "Hogs, Fresh Pork and Pork Products from Canada," March 28, 1985. It still remains for the International Trade Administration to make its final determination of subsidy and for the International Trade Commission to make a final determination of injury.

[21] United States, Congress, Congressional Budget Office, *Canada's Western Grain Stabilization Program: An Option for U.S. Farm Policy?* (Washington, D.C.: U.S. Government Printing Office, 1984).

its output, while a U.S.-based firm sells most of its output in the home market. Thus, countervail threatens the majority of the sales of the Canadian-based firm but only a small minority of the sales of the U.S.-based firm.

The Canadian Bargaining Position

For all of these reasons, Canadians need to be seriously concerned about the status quo with respect to U.S. countervail. What, then, should Canadians seek to obtain with respect to this policy tool in CAFTA negotiations?

One possibility would be to try for complete removal of the bilateral application of countervail laws. But this could raise issues about sovereignty if the two countries were to consider adopting the approach taken by the European Community. The EC Commission reviews subsidy practices of all member states and if it finds that particular subsidy practices distort competition then it can initiate legal action in the European Court of Justice.[22] It seems very unlikely that two countries with the disparity of population of the United States and Canada could, or should, agree to supervision of subsidy policies by a supranational authority.

In any case, it is doubtful that the U.S. Congress would agree to exempt Canada from its countervail laws. In view of the heavy use of subsidies as instruments of various Canadian national policies, it is hard to believe that the United States would accept full Canadian exemption from countervail. Therefore, we do not consider this possibility further.

What Might Be Accomplished

If complete Canadian exemption from U.S. countervail is ruled out, what does seem both desirable and possible? We give below some illustrations, by no means meant to be exhaustive, of what might be agreed to and written into the terms of a CAFTA.

(1) Agreement could be reached to freeze existing practices. This would mean that new policies that increased the trade-restricting power of countervail would not be permitted within the rules of a CAFTA. Such an agreement would serve two purposes. First, it would greatly reduce uncertainty as to what U.S. countervail policy was going to be a few years hence. Second, it would forestall some changes that could be very harmful

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[22] See Article 93, *Treaty Establishing the European Economic Community* (Treaty of Rome), 1957.

to Canada. For example, generally available subsidies would be agreed to be noncountervailable within the CAFTA, whatever changes the United States made in its policy with respect to countervail on the products of other countries.

(2) The two countries could agree to accept the general principle that the purpose of countervail was to remove unfair competition caused by subsidies available to producers in the other country but not available to competing domestic firms. To use a popular metaphor, when trade is unrestricted in both directions, the purpose of countervailing duties should be to establish a "level playing field". All disagreements on particular issues would be settled by applying this basic principle to the specific case.

(3) Several applications of this basic principle could also be written into a CAFTA. One of the most important would be that countervail would apply only to the differential between subsidies available to firms in one country and those available to similiar firms in the other. At present, Canadian goods can be subject to countervailing duties in the United States if they receive a subsidy in Canada, even if competing U.S. firms receive an equivalent or greater subsidy from U.S. federal or state governments. The current U.S. countervail action against Canadian hog and pork products is an example of this type of anomaly. The principle of fair competition would require that countervail be considered only when it could be shown that the imported good received a larger subsidy than was available to domestic producers. This suggestion could be implemented in a number of different ways. One option that would significantly limit the bilateral application of countervail would be to pass legislation preventing the initiation of cases where the industry on both sides of the border was subsidized. Another, more likely, option would be to apply the *de minimis* subsidy level to the subsidy *differential*, not the foreign subsidy. (*De minimis* subsidies are those that are less than half of 1 percent of the sale value of the product).

(4) The use of regional subsidies could also be permitted where the effect of the subsidies did not alter international trade patterns. In any CAFTA negotiations, Canada would seek to reserve the right to subsidize lower-income, higher-cost regions as a matter of national policy. This policy could be reconciled with the principle of fair competition by agreeing to base countervail on the costs that would have been available to a firm had it made its locational decision on the basis of market signals alone.

To illustrate what is involved, consider a simple example where unit costs are $0.80 in Ontario and $1.00 in New Brunswick. If a firm now takes a $0.15 per unit subsidy to locate in the Maritimes, its exports to the United States would not be countervailable. If, however, the subsidy were $0.30 per unit, then its exports would be countervailable to the extent of a $0.10 net subsidy. The principles involved here are, first, that it is of no concern to the United States if Canadians elect to lower their average standard of living by directing production away from its lowest-cost locations; while, second, it is of concern to the United States if Canadian subsidies allow Canadian firms to export at prices below those that would have been determined in a free market. This would be an important change from current U.S. practice, where such arguments were ruled out in the Michelin tire case. Writing it into a CAFTA agreement would recognize Canadian sovereignty in subsidizing its lower-income regions while recognizing the U.S. right to demand "fair competition" in internationally traded goods.

(5) Another option in a CAFTA could be to negotiate a list of acceptable subsidies not liable to countervail as long as they do not exceed a threshold level.[23] Provincial and state governments would have to put on the list all their current subsidy policies. The presumption is that many existing subsidies would be allowed, except where they seriously compromised the principle of fair trade. It would then be agreed that new subsidies could subsequently be added only by mutual agreement. This would provide Canada and the United States with some assurance that provincial and state policies would not provide for ever-increasing subsidization. Some restraint would also be applied to self-defeating, beggar-thy-neighbor, regional, or province-building policies — at least those that employ subsidies. The agreed list would provide much greater certainty to provincial governments and to the firms and workers that they wished to help, in assuring them that those subsidies on the permitted list would not subsequently attract countervail — especially after firms had accepted the subsidies and based their investment decisions on them.

Even if it were possible to agree upon only a few types of mutually acceptable subsidies, this could still remove existing ambiguities. Subsidies to improve environmental quality or occupational health, for example, could be exempted from countervailing procedures. At present, a Canadian smelter receiving a government subsidy to install a scrubber intended to reduce transborder movements of acid precipitants could be

[23] For example, Article 91 of the Treaty of Rome defines a list of acceptable subsidies.

potentially subject to U.S. countervailing duties on its output because the Canadian government has "assumed a cost" of production.

(6) Another way of controlling the application of countervail law would be to negotiate an exhaustive list of sanctionable subsidies. This would provide governments in both countries with a clear indication of the risks of pursuing subsidy policies. It would also prevent private petitioners from alleging that any and every government policy or practice constitutes a subsidy. The regulatory authority that administers the countervail law would be instructed not to accept a private-sector petition unless it alleged subsidies that were on the list of those that were agreed to be countervailable. Not only would this reduce the potential for harassment by private petitioners, but it would also help prevent changes in the administrative and judicial interpretation of the law resulting in further broadening of the types of government policies that were considered to be countervailable subsidies.

(7) There is considerable scope for both countries to agree on the precise methods of calculating subsidies. As a ruling of the U.S. International Trade Administration states:

> we have considerable latitude to calculate the value of a subsidy...In our opinion, all that is required of us is that the methods we adopt be reasonable.[24]

As we warned at the outset, the above seven points are no more than illustrations of what might be achieved with respect to countervail. The points are sufficient, however, to establish the following:

- Current U.S. countervail policies are a substantial threat to Canadian economic policy independence. This threat severely restricts our sovereignty by inhibiting the scope for Canadian domestic policies to subsidize firms, regions, industries, and possibly even particular activities in such ways that, by accident or design, they are given an advantage as exporters.
- Currently, there is great uncertainty because no one knows what will be found to be countervailable over the next few years. Neither the firms that are offered subsidies, nor the governments that offer them know what their freedom of maneuver really is on these matters.

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[24] United States, International Trade Administration, "Subsidies Appendix to Cold-Rolled Carbon Steel Products," p. 18016.

- A CAFTA could significantly reduce this uncertainty by freezing and codifying present practices.
- A CAFTA could reduce the current risks involved in regional policies that involve subsidies.
- A CAFTA could make countervail more effective in achieving its purpose of ensuring fair trading principles, while reducing its potential to act as a covert NTB.

So, once again we see that when inspected carefully, a CAFTA is capable of increasing our ability to follow our own policies without taking unacceptable risks about U.S. reactions to them — risks that are inherent in the status quo, but that could be reduced by some of the terms of a CAFTA.

This discussion has focused on Canada's interest in limiting U.S. countervail, but some of the proposed restrictions on the bilateral application of countervail would be of interest to U.S. exporters as well. Canada's new countervail law has an extremely broad definition of subsidies and has acquired many of the procedural features of the U.S. system.[25]

Antidumping Duties

In principle, antidumping duties are another procedure intended to ensure fair trade. They are generally designed to prevent firms from selling goods in foreign markets at prices below those in their own home market — although the test for dumping varies in complex ways at different times and places.

In practice, however, antidumping duties can be more than just a "fair trade measure". Depending on how dumping is defined, and depending on the time and money costs involved in a foreign firm resisting an antidumping complaint, such duties can become significant obstacles to trade.

The actuality, or just the threat, of antidumping duties is used a great deal in Canada, and U.S. imports are often affected. A typical case involves a U.S. firm that has sought to avoid some of the price-increasing effects of the Canadian tariff by absorbing some of the costs of transporting the goods from the U.S. factory to the Canadian market.

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[25] Canada, *Special Import Measures Act.* See also K. Stegemann, *Report of the Policy Forum on Special Import Measures Legislation*, Policy Forum Series no. 4 (Kingston, Ont.: Queen's University, John Deutsch Institute for the Study of Economic Policy, 1984).

Since many of the antidumping cases involve attempts to reduce the impact of the Canadian tariff on the export prices of U.S. goods, it is to be hoped that a CAFTA would solve part of the problem. When trade is free between the two countries, one reason for dumping would be removed.

What, then, might we expect from a CAFTA with respect to antidumping agreements?

Would both countries want to gain exemption from each other's antidumping duties? There is a strong case for answering "No". Producers in both countries worry about dumping from producers in the other country, and so would want protection, either through domestic laws against price discrimination or through antidumping duties levied at the border. Some observers feel that antidumping protection is more of a worry to Canadian producers because of the relative sizes of the two markets. They argue that dumping of a relatively small amount of output on the fringe Canadian market by U.S. producers is more likely than dumping of output onto the major U.S. market by Canadian producers. This belief gives Canada a special interest in preserving its right to levy antidumping duties on U.S. products. Canada should have no problem in agreeing to the same right for the United States to levy antidumping duties against Canadian products. Insofar as these duties achieve fair trade situations, both countries should have an interest in continuing them.

The fact remains that antidumping duties can potentially be misused as a surreptitious barrier to trade. An aspect of U.S. antidumping law that creates this potential is the "sales below cost" provision.[26]

Under this provision, the fair market value of goods sold in the home country is not used in determining the dumping margin. Instead, the dumping margin is calculated on the basis of the national price that would cover production costs and return a normal profit for the producer. For industries with substantial fixed costs and experiencing a cyclical downturn, such a provision goes beyond remedying dumping and becomes protectionist in its effect. There is as yet no analogous provision in Canadian antidumping law.

Apart from this particular provision in U.S. law, other aspects of antidumping laws and procedures might be the subject of discussion. U.S. interests tend to be concerned about our antidumping practices, while Canadians tend to be concerned about countervail. This creates a potential bargaining situation where we give the United States some of the

[26] United States, *Trade Act of 1974*, Section 321 (d).

security it wishes with respect to our antidumping, in return for the United States giving us some of the security we want with respect to its countervail procedures.

Temporary Import Relief

From a Canadian perspective, one of the most worrisome developments in U.S. trade policy has been the growing tendency to resort to "temporary" import restraints for industries subject to intense international competition. These import relief measures are distinct from other actions under U.S. trade legislation, such as antidumping or countervail, which often fulfill a function as fair trade rules. There is no such rationale for import relief actions.

Two principal instruments can be used to implement these import restraints. One is the formal imposition of quotas or tariff surtaxes for industries subject to "serious injury" under Section 201 of the *Trade Act of 1974*, as amended by the *Trade Act of 1979*. These safeguards, or "escape clause" actions, are permitted under Article XIX of the GATT and must be applied on an MFN basis — that is, they should not discriminate among imports from different countries. This instrument has rarely been used. It was implemented with quotas and tariff surcharges on specialty steel in the early 1980s. The U.S. administration chose, however, not to impose formal quotas or surtaxes when the copper and carbon steel industries petitioned for import relief in the summer of 1984. In the case of copper, the administration decided to reject the petition for import relief, while the decision on carbon steel was to seek voluntary export restraint (VER) agreements with suppliers other than Canada.

These VER agreements are the other instrument available to protect industries from import competition. Arrangements of this type pervade the clothing and textile sector. The most prominent of these informal restraints are the VER agreements with Japan on automobiles. The U.S. VERs on automobiles and carbon steel have not affected Canadian exports adversely. Indeed, Canadian exports have increased because of the preferential access to the U.S. market that has resulted.

What, then, could we hope for from a CAFTA with respect to these "temporary" measures?

Despite the fact that Canada has emerged relatively unscathed from U.S. import relief measures, the threat of such actions increases the risks to investment in Canada today. A CAFTA signed under Article XXIV of the GATT could formalize, and thus make more secure, the informal exemption that both countries currently provide each other in the appli-

cation of safeguard actions. In particular, the two countries could agree to exempt each other from quotas or tariff surtaxes when the other country is not the principal supplier of the product in question. This would formally end the "sideswipe" problem, where a measure aimed at some other country is also applied to Canada or to the United States.

Complete exemption from bilateral safeguard actions might not be possible on products where Canada or the United States is the principal supplier of exports to the other country. The purpose of a safeguard provision is to provide a safety valve for pressures arising from import competition. Nonetheless, the recourse to safeguard actions should be sharply constrained on bilateral trade or else the basic principle of a free trade area would be undermined. One possible solution would be to limit bilateral safeguard measures to tariffs — precluding the use of quotas — and to limit the bilateral tariff to the external MFN tariff. In effect, a bilateral safeguard measure would amount to an exclusion of a particular commodity, on a temporary basis, from the terms of a CAFTA.

Once again, these are only illustrative points, but they do suggest that some valuable increase in the security of access to the U.S. market could be gained from the terms of a CAFTA. Canada would have to accept similar obligations on the use of safeguard measures as would the United States. Outside of sensitive sectors, such as agriculture, this is unlikely to pose major problems for Canada. Except for agricultural products and occasional special cases, such as specialty steel, where Canada specifically retaliated against U.S. quotas, most Canadian import relief measures — footwear quotas, for example — are directed at other countries and have only "sideswipe" effects on U.S. exports.

Balance of Payments Restrictions

There is an international presumption that countries will not resort to quotas to stabilize their balance of payments position.[27] If, however, such measures are used, there is a strong case for both countries exempting each other from the application of quotas or tariff surtaxes introduced because of balance of payments emergencies. Any such measures seem inimical to the spirit of a free trade area.

Since about 70 percent of Canadian imports come from the United States and only 20 percent of U.S. imports come from Canada, this commitment involves a greater restriction on Canadian than on U.S. policy.

[27] According to the Framework of Understanding negotiated in the Tokyo Round, the industrial countries are expected to avoid the use of import restrictions to restore balance of payments equilibrium.

The Canadian economy is also more dependent on bilateral exports, and the potential disruption of exports is a much more important consideration for Canadian policy.

Investment Policy

In contrast to common markets, free trade areas do not require the free movement of labor and capital among the contracting countries. Nonetheless, some Canadian response would be needed to U.S. concern over past Canadian policies on foreign investment. The United States wants to avoid the repetition of some of these Canadian policies and to have a more secure climate for investment in Canada, just as we wish to have a secure climate for exports to the United States. This constitutes an important bargaining chip for Canada, and we should be willing to put our behavior with respect to foreign investment on the negotiating table.

What should Canada be willing to include on investment policy in the terms of a CAFTA?

First, we would *not* need to agree to the complete and unrestricted access to Canada of U.S. capital. We could reserve the right, as do almost all nations, to restrict foreign ownership in areas that are particularly sensitive to considerations of national interest. This would include many cultural areas and could, if we wish, include energy. What we should offer is to agree to national treatment of U.S. investment once it is admitted. This would be a significant change from our past policy, and it has four aspects:

- Allowable discrimination consists of deciding whether or not to admit the foreign investment. If it is to be admitted, it should be subject to the same conditions as domestic investment. So we should agree not to do what the Foreign Investment Review Agency often did, which was to impose conditions with respect to employment, research and development, and exports that were not required of Canadian investors.
- Once the investment is in place, taxes, subsidies, and other measures that discriminate according to ownership should not be introduced. (This only formalizes what are generally agreed to be reasonable rules of international investment behavior — although they are rules Canada has sometimes violated in the past.)

- The application of performance requirements to firms in regard to procurement of goods and services should be ruled out.[28]
- It seems to us that the best approach to investment policy would be to remove all screening of foreign investment except in sensitive designated sectors. The proposed legislation for Investment Canada removes most of the impediments to establishing a new business but retains the screening of acquisitions by foreign-owned corporations.[29] One reason that might be advanced for retaining such screening is that it would prevent potential predatory behavior such as a multinational buying a Canadian company in order to close it down. But that is a rationale for the reform of Canadian competition laws to regulate mergers and acquisitions. Canada is unique among the industrial countries in its tendency to regulate foreign investment as an alternative to competition policies.[30]

The most contentious of these four principles would be the last. From the U.S. point of view, it would be one key aspect of the principle of national treatment of investment: once admitted, foreign firms should be allowed to indulge in any commercial behavior that is allowed of Canadian-owned firms. From the Canadian point of view, existing practices are a serious inhibition to investment in Canada by foreign or domestic firms. The effect on investment can be put succinctly in the phrase, "exit barriers are entry barriers". A foreign-owned multinational considering entering Canada, or a Canadian firm choosing whether to invest at home or abroad, would ask itself the question, What if the venture turns out to be a mistake, or what if we change our strategic objectives? The firm might then want to sell its assets, but the uncertainty over who would be permitted to tender for an operating business venture in Canada would reduce the expected value of those assets at the time of sale. This increases the present risk, and reduces the incentive to invest in the first place. At a time when there is a worry about the adequacy of

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[28] For a discussion of the issue of performance requirements, see A.E. Safarian, "Trade Related Investment Issues," in W.R. Cline, ed., *Trade Policy in the 1980s* (Washington, D.C.: Institute for International Economics, 1983), pp. 611–638; and H.E. Bale, "Trade Policy Aspects of International Direct Investment Policies," in R.E. Baldwin, ed., *Recent Issues and Initiatives in U.S. Trade Policy* (Cambridge, Mass.: National Bureau of Economic Research, 1984), pp. 67–100.

[29] Canada, Department of Regional Industrial Expansion, "Government Introduces Legislation to Encourage Investment in Canada," *News Release*, Ottawa, December 7, 1984.

[30] A.E. Safarian, *Governments and Multinationals: Policies in the Developed Countries*, BNAC no. 33 (Washington, D.C.: British-North American Committee, 1983), p. 77–78.

the flow of employment-creating direct investment into Canada, such an avoidable disincentive is undesirable.

Regularizing our behavior toward foreign investment, along lines that are generally agreed to be in accord with internationally accepted rules of the investment game, would give valuable security to U.S. investment. Furthermore, if we did this for U.S. investment, we would be unlikely to behave much differently toward investment coming from other countries. This would make us a more secure place for foreign investment in general and, therefore, would help offset any tendencies that some see for a CAFTA to drain investment away from Canada.

Resource Policies

Many Canadians share a deep-seated fear of losing control over their natural resources. Canadian energy policy has sometimes given expression to these fears through a differential treatment of investment and profits based on ownership of firms in the energy sector. Of course, it was the National Energy Program that aroused most controversy over such issues.

What might be the implications of a CAFTA for resource policies? The guiding principle should be to retain the right to control the use of our natural resources in the national interest, while giving up the right to use resource policies both to confer unfair advantages to Canadian exports and to violate the principle of national treatment of whatever foreign investment is allowed into that sector.

First, let us look at some of the powers that Canada would keep after a CAFTA was formed:

- Canada would retain the right to control the rate of extraction of natural resources in general, and petroleum in particular. Canadian provinces control resource exploitation within their boundaries, while the federal government regulates resource development on the continental shelf and in northern Canada. Provided these controls were applied in a way that did not discriminate on the basis of national ownership, the policy could be adjusted to achieve any feasible extraction rate that was thought to be in the public interest.
- Canada would retain the right to hold Canadian energy prices above, or below, world prices. There is debate on the desirability of such policies, with economists tending to be opposed to them in most circumstances. Be that as it may, this is a right that could be maintained. (Holding local energy prices below world market prices is analogous

to applying a generally available subsidy that is not countervailable under current U.S. practices.)

- Canada would retain the right to control new entry of foreign capital into the energy field. The main principle here is that the controls should not be used in such a way as to drive down the value of foreign capital once it is in place, so that it can then be bought out by Canadians at "bargain basement" prices. It is easy to state such a principle, and hard to give it effect in detailed practice. The screening of new firms by Investment Canada would not cause problems. The buying out of foreign investments at fair market value should not cause difficulty. The acquisition of existing capital by existing firms would be more contentious. Currently, investment Canada has the right to screen, and disallow, any takeover of one foreign subsidiary by another. This practice was discussed in the previous section. Even if it was abandoned in general, it might be retained in the energy field by special exemption.
- The right to tax Canadian-source earnings of foreign nationals through the withholding tax would not be at risk.

The first and fourth of these points would not be seriously challenged. After all, the United States is not going to dismantle the Texas Railway Commission, which controls petroleum exploitation in that state. The right to levy withholding taxes has just been reaffirmed in the new Canadian-U.S. tax treaty. The second point might be subject to debate, but in light of the countervail precedent, it should be something that can be supported. However, most problems would arise with the third point. Agreement in principle that both countries have the right to control foreign capital at the border would not be difficult. Where problems would arise is with capital acquisitions of existing foreign firms. Details would have to be hammered out in bargaining and then enshrined in the CAFTA agreement.

Now consider what the United States would likely request:

- Canada would give up the right to levy tax and subsidy policies that distinguished among firms on the basis of their nationality. This is a tool that has often been used in the past. Although this would represent a loss of sovereignty, it would only bring Canadian practice into line with general principles of national treatment of firms once they have been allowed into the country.
- The Canadian federal government and the provinces would give up the application of certain types of performance requirements for foreign

companies engaged in resource development.

• Canada would give up differential pricing that distinguished among firms on any basis — nationality or otherwise. Thus, while it would be acceptable to hold the price of petroleum below the world price for all Canadian users, it would not be permissible to do so for selected users — say, firms in one industry. An example of what would be ruled out is the remission for petrochemical firms of the recent increase in the petroleum compensation tax.[31] Insofar as such users were exporters, this policy would, in any case, be countervailable under today's practices. Canada would simply be giving up the questionable right to use energy pricing policy as a concealed subsidy to specific firms. Of course, Canada could choose not to negotiate this principle and run the risk of countervail.

Notice also that any loss of sovereignty would be reciprocal. These are not cases of giving over to the United States the power to make key decisions on Canadian resource use. Both countries would have to agree to give up the right to do certain things that offended the principles of fair trade and national treatment of investment. The policy tools that affect the rate of extraction, the domestic prices, and the degree of foreign ownership of our resources would remain fully under Canadian control.

Summary

In this chapter, we have surveyed some of the key issues that would arise in negotiation of a free trade area involving Canada and the United States. Some of the issues, such as the inclusion of industrial sectors and rules of origin, are issues that have been dealt with in previous free trade area negotiations.

Other aspects of the negotiations would break new ground in international economic relations and involve significant compromises in the policies of both countries. On the U.S. side, this would involve substantial refinement of a system of contingent protection that, from a Canadian perspective, appears to be a very blunt instrument. On the Canadian side, this would involve commitment to avoid the application of regulatory and tax policies that have been regarded as discriminatory by the United States.

We do not underestimate the institutional and legal complexities that

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[31] The Hon. Michael H. Wilson, *A New Direction for Canada: An Agenda for Economic Renewal* (Ottawa: Department of Finance, November 1984).

must be addressed, or the difficult political decisions that both countries would have to make. But we have attempted to sketch the parameters of a potential core area of agreement that could provide a basis for negotiations.

9

Implementing a CAFTA: How Can It Be Done?

An important aspect of a Canadian-American Free Trade Area (CAFTA) is its implementation. One objective is to address concerns about the economic adjustments that would confront some firms and workers. Another objective is to ensure that the detailed package that would be negotiated is effectively implemented in the domestic legislation of both countries. A third objective is to make the agreement durable enough to cope with disputes without systematically eroding the degree of trade liberalization achieved or precipitating the agreement's complete collapse.

Transition Arrangements

The lowering of Canadian trade barriers would increase competitive pressures, while the reduction of U.S. trade barriers would open export opportunities for Canadian producers. Similarly, some U.S. companies would expand exports to Canada while others would experience more import competition in their domestic market. The costs of adjustment for affected firms and workers could be lowered by phasing in the reduction in trade barriers, and by providing government adjustment assistance programs for displaced workers.

Phase In

There will be genuine concerns on both sides of the border about adjusting to a CAFTA. For this reason, the changes should be phased in over a sufficient period of time so as to allow the adjustment to proceed in an orderly fashion. It is, of course, possible that the adjustment would be smoother than expected, as it was in Europe. It would then be possible to shorten the phase-in period by mutual agreement.

Some delay in reaching full trade liberalization would not upset investment too much because, once a timetable was agreed to and the ad-

justment begun, firms making new investment would have a clear anticipation of the future market availability.

Canada would have a larger adjustment problem than would the United States since a higher proportion of total Canadian resources are engaged in production for export. Also, current tariffs are higher in Canada than in the United States, so Canadian industry would lose more protection than would U.S. industry (see Table 5 in Chapter 5). For these reasons, an asymmetry in the adjustment process is desirable. This asymmetry is one of the major concessions that Canada should seek to obtain from the United States in return for taking part in the trend-setting model case on a really important piece of trade liberalization that includes services and investment policies, both of which are of concern to the United States.

An extreme proposal would be for the United States to remove all of its barriers immediately, while the Canadian reductions were phased in over a period of, say, five or seven years. This would help Canadian adjustment, because those firms destined to succeed in the North American market would be expanding before those that would not survive Canadian tariff reductions began to contract. Also, the slow rate of tariff reduction would give substantial time for the adjustments to take place even if the adjustments proved to be larger than we predict. This might be the opening Canadian bargaining position, and concessions in other directions might make it sustainable.

If it were not, then an intermediate position would be to propose, say, twice the rate of tariff reductions in the United States than in Canada. U.S. tariffs, for example, could be scheduled to reach zero in four years, while Canadian tariffs reached zero in seven or eight years.

Another way of obtaining an asymmetric adjustment process would be to agree, say, that one percentage point would be taken off each tariff rate each year until the rate reached zero. Since, on average, Canadian tariffs are higher than those of the United States, this would automatically give an asymmetry to the adjustment period.

No doubt other schemes could be imagined, and the details could be the subject of some hard bargaining. What is important, however, is that the two countries agree at the outset that a substantial difference in the adjustment periods would be justified by their very different degrees of exposure to competition from one another.[1]

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[1] The potential asymmetry between Canada and the United States in adjusting to freer bilateral trade is recognized by U.S. economists. See M. Kreinen, "North American Economic Integration," *Law and Contemporary Problems* 44 (1981): 24.

Since the reduction in trade barriers would be gradually phased in, and if, as proposed, Canadian barriers are removed more slowly than U.S. barriers, Canadian firms would be able to depreciate existing plant and equipment that is sheltered by import barriers, to retool their operations to meet new competitive challenges, and to invest in new world-class production facilities.

Of course, the date of the commencement of the reductions in tariffs and other trade barriers would depend partly on when the negotiations were finally completed. But an ideal target date would be shortly after the Tokyo Round tariff reductions are completed in January 1987. If that were possible, the CAFTA reductions would just continue the trade-liberalizing process set in train by the Tokyo Round agreements.

Safeguard Arrangements

The rapid penetration of the goods from a particular industry in one country into the other country's markets could cause real hardship during the phase-in period. Some sort of pressure-release mechanism might be desirable for such cases. Details would have to be worked out in negotiations, but it would be important to ensure in advance that the measures were only temporary. If, after some relief period, a set of firms just could not compete, they could not be sheltered indefinitely. Another important principle is that, if adjustment is to be encouraged in the protected industry, tariffs would be preferred to import quotas. Thus, one safeguard measure would be to postpone scheduled tariff cuts for one or two years under specified circumstances. As discussed earlier, temporary tariffs could be imposed, but with each country's import tariffs from third countries constituting a ceiling on such increases.

Adjustment Assistance

One area of concern is the potential displacement of workers in industries affected by trade liberalization. Although most workers would gain from the greater diversity of employment prospects and the potential for increased real income, some may not. Among the workers most at risk are those employed in highly protected industries, who are older, have a limited range of skills, and live in communities with limited employment alternatives. As argued earlier, many of these vulnerable workers will face declining prospects over the next decade, whether or not there is further Canadian trade liberalization.

One response to the problems of labor market adjustment consists of

generalized adjustment policies as part of a "climate-based" strategy to facilitate industrial adoption. Such policies include government assistance for both institutional and on-the-job training activities, and relocation. Although the latter could take the form of mobility grants, the tax system also operates to assist worker mobility. Recently, Canadian income tax law was amended to permit unemployed and previously employed people to claim moving expenses against income tax. The value of tax incentives for worker mobility could be enhanced for low-income people by replacing the existing system of deductions for moving expenses with a tax credit. Similarly, pension reform measures that led to earlier vesting of pension benefits would contribute to employee mobility and reduce the risks to workers from firm closures or layoffs.

Special policies to cushion the impact upon workers most vulnerable to trade liberalization could also be implemented. Such policies could involve early retirement programs for older workers and portable wage subsidies to help workers obtain employment in other activities.

It is often difficult to link the layoff of workers to import competition.[2] Thus, such assistance programs could be made available to all laid-off workers in industries subject to substantial reductions in import protection. The amount of assistance could be proportional to the number of years each person had been employed in the industry.

An Executive Agreement or a Treaty?

What kind of an agreement is to be negotiated? This question has special significance, given the U.S. Constitution with its system of checks and balances and the division of powers among the executive, legislative, and judicial branches of government.

One option is an executive agreement that could be legislated by a "fast-track" procedure in Congress. The enormous advantage of the fast-track process is that Congress would only get the chance to say "yes" or "no". It would be unable to amend the details of the agreement or add riders to the legislation. The disadvantage is that it would not be as formal as a treaty both in law and psychology, and so it would be easier to undo.

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[2] See H. Bratt, "Issues in Worker Certification and Questions of Future Direction in the Trade Adjustment Assistance Program," *Law and Policy in International Business* 14 (1982): 819–858; and J.D. Richardson, "Trade Adjustment Assistance under the United States Trade Act of 1974: An Analytical Examination and Worker Survey," in J.N. Bhagwati, ed., *Import Competition and Response* (Chicago: University of Chicago Press, 1982), pp. 321–368.

The other option is a formal treaty. The disadvantage of a treaty is that it would have to pass the Senate, where it could be scrutinized in detail. Once the negotiators from both countries had each made their compromises, it would be upsetting to have the Senate start renegotiating carefully worked out agreements, particularly when changes that the Senate would want to make would naturally favor the United States alone.[3]

One advantage of a treaty is that in the United States, treaty provisions override existing federal and state laws. Thus, a treaty giving national treatment to Canada could eliminate both federal and state nontariff barriers to trade.[4]

Another advantage of a treaty is that once passed, it really would offer security for the future. Abrogation would be very unlikely and those making economic decisions on both sides of the border could plan in an atmosphere of relative certainty about the policies of the two countries with respect to transactions between each other.

The approach that seems most fruitful to Canada would use both the treaty and the fast-track route. A treaty could be used to enshrine the general principles of a CAFTA, including, for example, the principle of national treatment. Detailed elements of the negotiated package, such as the exclusion of certain industries from trade liberalization and methods of restraining the use of nontariff barriers (NTBs), could be introduced into Congress for "fast-track" consideration. This approach would have the great advantage of allowing Congress to scrutinize in detail the general principles of a CAFTA while keeping its details out of the arena of congressional debate.

Although the "fast-track" procedure would be immune from detailed reconsideration by Congress and, hence, could be passed as a coherent whole, it would not be immune from subsequent amendment. Some legal provision that would preserve it from perennial amendment would be most desirable. Whether such a provision could be written into the

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[3] For accounts of the difficulties with the negotiation of the East Coast Fisheries Treaty, see S. Clarkson, *Canada and the Reagan Challenge* (Ottawa: Canadian Institute for Economic Policy, 1982), pp. 206–212; and D. Leyton-Brown, *Weathering the Storm: Canadian-U.S. Relations, 1980–83*, CAC no. 51 (Toronto; Washington, D.C.: Canadian-American Committee, 1985), pp. 19–20.

[4] See J.H. Jackson, "United States Law and Implementation of the Tokyo Round Negotiation," in J.H. Jackson, J.-V. Louis, and M. Matsushita, *Implementing the Tokyo Round: National Constitutions and International Economic Rules* (Ann Arbor: University of Michigan Press, 1984), pp. 142–145.

treaty is a moot point, and would have to be settled by constitutional experts.

Dispute Management

Disputes would inevitably arise and some form of management would be needed. The Canadian-American Committee has put forward one approach to the management of bilateral relations. The Committee recommends some broad principles that should guide the actions of both governments. These principles are:

- avoid unilateral policy actions that disregard the bilateral consequences;
- engage in prior consultation;
- seek to use policy instruments that minimize adverse effects on the other country; and
- avoid the use of linkage as a coercive tactic.[5]

Unless both countries support the principle of bilateral cooperation, detailed agreements about formal procedures are unlikely to be effective.

The Canadian-American Committee's study also analyzes bilateral disputes over Canada's National Energy Program and Foreign Investment Review Agency. It concludes that an appeal to multilateral dispute-settlement procedures under the General Agreement on Tariffs and Trade (GATT) could help to resolve such disputes.[6] Since Canada and the United States would continue to participate in the GATT, at least some bilateral issues could continue to be dealt with through multilateral procedures.

For certain types of bilateral problems, the International Joint Commission — which has quietly worked on border disputes involving such environmental matters as the use of boundary waters — offers some relevant experience.[7] This type of agency would be of most use in settling the detailed but important issues that affect individuals or small groups but that do not involve great issues of national policy. Whether an equivalent institution for trade and investment disputes would be useful is something to be further considered. We have already mentioned that where the covert use of disallowed NTBs would be hard to detect, a complaint

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[5] Canadian-American Committee, "A Statement to Accompany the Report," in Leyton-Brown, *Weathering the Storm*, p. vii.

[6] Leyton-Brown, *Weathering the Storm*, pp. 34–35.

[7] For a discussion of the role of the Commission, see J.E. Carroll, *Environmental Diplomacy: An Examination and a Prospective of Canadian-U.S. Transboundary Environmental Relations* (Ann Arbor: University of Michigan Press, 1983), Chapter 2.

body might be valuable. No matters of great principle would be involved. The issues would be nitty gritty ones such as whether a particular professional practice was discriminating against the suppliers of a service on the basis of nationality, or whether particular antidumping complaints were being used to harass foreign suppliers in unfair ways. Of course, such a body would not provide foolproof protection against the covert use of NTBs, but it might provide a useful fact-finding mechanism for legitimate ambiguities, and it could provide a warning signal when too many cases of one sort began piling up on the agenda.

Sooner or later, however, disputes would arise that involve important bilateral policy issues. Then the choice open to the national governments would be to negotiate on an ad hoc basis or to work through some permanent institutional arrangements. As was discussed earlier in the context of subsidies and countervailing duties, given the asymmetry in the relative size of the two economies, it seems unlikely that the two governments would cede sovereignty to a supranational institution.

This asymmetry suggests that, to the maximum extent possible, dispute settlement should be based on "rules" and not on reference to relative "power positions". Toward this end, John Jackson has proposed that the United States, Canada, and other countries enter into a protocol on disputes settlement.[8] This proposal was intended to remedy deficiencies in the GATT procedures, but it could be applied equally to a CAFTA.

Abrogation

One of the most commonly expressed worries is that Canada would be vulnerable to the threat of unilateral U.S. abrogation of a treaty. There is some evidence on this issue from the history of the autopact. It would be much less upsetting to abrogate a sectoral arrangement than an entire CAFTA treaty. Yet, although the United States threatened abrogation in the autopact case — in retaliation to Canadian behavior about which it was seriously concerned — the threat was never carried out.

Our own consideration of the possibility leads us, however, to believe that unilateral treaty abrogation would be a very unlikely event, for the following reasons:

- The United States would like to have such a treaty to demonstrate to the rest of the world that trade liberalization is still possible. For the

[8] J.H. Jackson, "Governmental Disputes in International Trade Relations: A Proposal in the Contect of GATT," *Journal of World Trade Law* 13 (1979): 1-21.

United States unilaterally to abrogate such a treaty with one of its best friends and customers would be a most unfortunate signal to the rest of the world. The message that the United States could not be relied on to keep any commitment on which its friends counted, and based their plans upon, would be quite devastating to its credibility.

- There would be significant costs to those U.S. firms that sold to Canada, or bought tariff-free materials from Canada. These costs would be large and visible to those suffering them. The affected firms would constitute a strong constituency within the United States that would oppose abrogation.
- Some argue that there is a significant precedent for the present in the unilateral U.S. abrogation of the Reciprocity Treaty between the United States and Canada in 1866. Those were, however, different times, when the United States had no cause to worry about a world leadership role, and when changes in trading relationships with Canada had small adverse effects.

There are also reasons to believe that even in the very unlikely event of abrogation, the effects on Canada would be much smaller than the "disaster scenario" suggests. After all, both countries are members of the GATT. Abrogation would not return us to a world of high trade restrictions, but only to those relatively modest ones that are consistent with both countries' commitments to the GATT. Furthermore, abrogation, should it occur, would have less effect on a Canadian economy rationalized to achieve world-competitive costs than would the equivalent increase in U.S. trade restrictions now.

The worry is often expressed that the threat of abrogation would constrain Canada's ability to take independent stands on other matters where these stands would be unpopular with the United States. We have argued, however, that the threat of abrogation is very small. Furthermore, it is evident to all observers that the presently existing threat of unilateral piecemeal changes in U.S. trade practices is a very real one. This is evidenced, for example, by various trade-restricting bills currently before the U.S. Congress. As long as the U.S. dollar remains high, such threats will be strong, and it is in the nature of the political process that the restraining forces would be weakened if Canada did something in the international sphere that aroused U.S. disfavor. Thus, we believe that the fear of abrogation is misplaced. In reality, the threat of significant changes in U.S. trade policy toward Canada already exists. It seems to us that the protection against such threats that a CAFTA treaty would

provide would increase, rather than diminish, Canadian policy independence. In this aspect, as in so many others, a CAFTA would not erode our political independence; it would add to it.

Summary

A carefully designed package of measures to phase in the implementation of a CAFTA and to ease the subsequent adjustment would ensure that the gains from freer trade are realized at minimum cost. Since Canadian industry would need to do more restructuring than that of the United States, we have proposed that the reduction of trade barriers be asymmetric.

Similarly, Canada could never obtain complete invulnerability to erosion of the negotiated access to U.S. markets or to the agreement's abrogation. Legal and institutional arrangements could, however, help secure a CAFTA. But the best protection would be that a wide range of U.S. domestic interests have a stake in the arrangement.

PART IV

Conclusion

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It's Canada's Move

On balance, the Canadian economy has performed well over the years since World War II. Canada's prosperity is heavily dependent on foreign trade, and trade has grown greatly over the period. As a result of reductions in tariffs negotiated in successive rounds of the General Agreement on Tariffs and Trade (GATT), much of Canadian production has been rationalized to achieve world-competitive costs, and this has allowed increased export penetration, particularly into the U.S. market. Many tariffs still remain high, and further trade liberalization is needed to bring the entire range of Canadian industry into the global marketplace with competitive costs.

The Challenges

Currently, however, the Canadian economy faces unavoidable challenges. Lower-income countries, such as China, are increasing their shares of world markets in labor-intensive, consumer goods. The maturing industrial capabilities of the newly industrializing countries (NICs) pose a direct challenge to basic industries in all established industrial countries, including Canada. Rivalries among the industrial countries in the development of new technologies are intensifying. These are irreversible forces.

Under the impact of an unprecedented trade deficit, protectionist pressures are increasing in the United States. Canada risks being "sideswiped" by U.S. measures directed at third countries. Furthermore, some U.S. measures are directed specifically at Canada. As long as U.S. export- and import-competing industries remain under heavy pressure due to the overvalued U.S. dollar, protectionist pressures will, quite understandably, increase in that country.

Eventually, there will be a realignment of exchange rates and the enormous U.S. trade deficit will be reversed. But the accumulation of foreign debt by the United States and the simultaneous accumulation

of foreign assets by Japan will permanently alter world trade flows. Protectionism may decline in the United States and Europe when Japan becomes a substantial importer, but this will depend in part on whether the industrial countries adapt successfully to the competitive challenges of the NICs.

The Unacceptability of the Status Quo

Canadian policymakers will be following a very risky course if they assume that more secure access to the U.S. market will evolve out of the natural interplay of these forces; the possible time span is just too long. The forces shaping global trade patterns and straining the world trading system make the status quo an increasingly less attractive option for Canada. If, indeed, it is possible to define a status-quo option at all, it is only as a passive and reactive response of Canadian policy to external pressures.

Such an essentially passive and reactive Canadian policy offers no promise of being able to deal effectively with the risks of rising foreign protectionism, particularly in the United States. One of these risks is that the United States will not continue to apply its current implicit policy of granting exemptions for Canadian exports in the application of trade restrictions, as it has in the case of restraint arrangements on automobiles and carbon steel. Another risk is that the application of U.S. fair trade laws will impose inappropriate restrictions on Canadian exports and domestic policies, as appears to be the case with the recent countervail determination on Canadian hog and pork exports. Further serious risks arise out of the U.S. Congress's increasing aggressiveness in shaping U.S. trade policy. *The Trade and Tariff Act of 1984* contained provisions that would have significantly altered U.S. countervail law, with adverse consequences for Canada's resource exports. These measures, directed in part at Canada's resource policies, were only amended at the last minute, and attempts are likely to be made to attach them to future U.S. trade bills.

Even if Canada continues to emerge relatively unscathed from the direct effects of U.S. trade restrictions, the mere risk of such measures has created strong pressures for manufacturers to invest in the United States rather than in Canada.

Thus, the status quo seems fraught with dangers. It is important to recognize that holding present policies constant would *not* entail maintaining the Canadian economy in its present position. Instead, the in-

evitable buffeting by the many ongoing forces of change in the world trading regime would evoke ad hoc policy reactions. These could easily push in the wrong direction, toward policies that seek to protect existing jobs, thereby reducing future employment opportunities and turning Canada in an inward-looking direction.

Bilateral Trade Liberalization with the United States

The only option that offers both a defense of Canada's existing markets and an opening of new markets through which Canadian industry's further rationalization can be achieved is comprehensive bilateral trade liberalization with the United States — which does not preclude pressing for further multilateral trade liberalization as well.

Within the bilateral option, one might try such piecemeal approaches as sectoral free trade agreements and functional agreements on specific nontariff barriers (NTBs). These, however, are likely to produce a minimum of results for a maximum of negotiating effort. The other approach, within the bilateral option, is a comprehensive trade-liberalizing agreement with the United States. The major advantage of the comprehensive over the piecemeal approach is that the negotiations would start with the assumptions of providing complete coverage of all merchandise and service trade flows and of eliminating substantially all trade barriers. Exclusions would be permitted only for very special cases.

The comprehensive bilateral approach to trade liberalization with the United States is referred to by a variety of names, such as "trade enhancement", "trade liberalization", and "a free trade area". It is important to realize that people who use these different names are all talking about the same thing: freedom of access on a national treatment basis, and on as broad a range as is possible, of each country's goods and services into the other's market. We have used the name it would be given under Article XXIV of the GATT — and under which it would need to be accepted — although we recognize that *complete* free trade is an ideal that can never be fully achieved. A Canadian-American Free Trade Area (CAFTA) would, however, involve eliminating substantially all bilateral tariffs and quantitative restrictions on trade in goods and services. In addition, it would involve control of NTBs, including the contingent protection systems of both countries and the nondiscriminatory application of public procurement and regulatory policies.

What the Debate Should Now Be About

Negotiating a CAFTA would break new ground in international economic relations and require compromises by both countries. The important details of the agreement deserve public debate now. This debate should be informed by an understanding of the interests of both countries and of the potential for mutual gain.

The U.S. Viewpoint

The U.S. interest in a CAFTA would be to obtain better access to the Canadian market and greater security on Canadian investment policies. At present, the Canadian market is by far the largest for U.S. exporters, accounting for 22 percent of total U.S. exports. The bilateral reduction of the higher Canadian tariffs would confer a substantial benefit on U.S. exporters — particularly since Canadian tariffs on goods coming from other countries are unlikely to be reduced rapidly through multilateral negotiations. Also, the United States is particularly interested in expanding markets for the export of technology-based goods and services. On the investment side, the United States has extensive interests in Canada, amounting to 30 percent of its total direct investment in the industrial countries. Obtaining greater security for this investment against unpredictable, and sometimes discriminatory, shifts in Canadian investment policy would be a significant achievement for the United States.

The Canadian Viewpoint

The Canadian interest in a CAFTA would be to obtain more secure access to the large U.S. market and to diminish the relative attraction of the United States as a place from which to serve the North American market. The structure of U.S. tariffs impedes further processing of Canadian resource products and inhibits the development of world-competitive manufacturing industries. Various U.S. nontariff barriers, such as government procurement preferences, as well as the risks created by the U.S. system of contingent protection, create incentives for Canadian firms to channel new investment into the United States. Given Canada's dependence on exports to the United States, anomalies in U.S. countervail laws and the risks of countervailing duties pose particular hazards for Canadian efforts to promote investment.

There is evidence that Canadian bargainers have been able to hold their own in bilateral negotiations with the United States in the past. Nonethe-

less, many Canadians worry that a major trade-liberalizing agreement with the United States would require an excess of Canadian concessions. Both countries have their own areas of particular concern, however, and these should provide the grounds for an overall, balanced agreement. For example, Canada would seek to limit the potential for excessive use, or abuse, of the U.S. contingent protection system and other NTBs, while the United States would seek Canadian commitments to national treatment of services and U.S. investment in Canada.

Exclusions

Some industries in both countries will seek to be excluded from the bilateral reduction of trade barriers. To the maximum extent possible, these industries should be brought into the scope of the arrangement, although perhaps with longer phase-in provisions where the industries are particularly vulnerable.

There will be sensitive areas, however, that one or both countries may wish to exclude from the scope of the agreement. Canada has particular concerns about the preservation of cultural independence. Some of the more discriminatory effects of Canadian policies, such as the income tax provisions affecting U.S. border radio and television stations, would likely have to be eliminated. But Canada would be able to retain a broad policy independence to support cultural activities. Indeed, both countries would likely continue to limit the foreign ownership of radio and television stations, so that these activities would have to be excluded from any general agreement over the right of establishment.

Some of the current restrictions on bilateral trade and investment in both countries result from the policies and practices of state and provincial governments. In the United States, the federal government can legally override state practices, but this is not the case in Canada. To achieve a comprehensive agreement providing national treatment of services and investment, the Canadian federal government would need to seek the participation of the provinces in the implementation of a CAFTA. For both countries, broadening the scope of the agreement to cover the practices of subnational governments would require consultation with those governments and the mobilization of political will.

Adjustments

In coping with import competition as trade barriers are dismantled, Canadian producers would face greater adjustment costs than would U.S.

producers. To help deal with this problem, U.S. trade barriers could be eliminated on a faster timetable than those of Canada. In addition, adjustment assistance measures could be provided to older workers employed in industries that are particularly vulnerable to import competition.

It's Canada's Move

The crosscurrents of political pressures on the U.S. Congress suggest that decisive action is necessary soon. The United States has not yet abandoned its predisposition for freer trade. Thus, it can be expected to respond positively to a Canadian initiative to negotiate a broad trade-liberalizing agreement covering goods and services and guaranteeing national treatment of investment.

The Absence of Satisfactory Piecemeal Solutions

Canadians have to realize that there is no piecemeal solution to today's trade problems. We should continue with multilateral negotiations, but assuring permanent changes in our economic prospects requires permanent changes in our trade policy. There is no solution to be found in piecemeal bilateral trade liberalization with the United States either. Simply seeking exemptions or exceptions to the rising tide of NTBs is a minor and ineffectual variation on the status quo. This approach is incapable of providing the thrust Canada requires to undertake needed industrial rationalization.

The Window of Opportunity

Agreement to commence negotiations for a CAFTA has to be reached very soon, for two reasons. First, the U.S. administration's authority to undertake negotiations for a free trade area is provided by the *Trade and Tariff Act of 1984*, which requires that there be a 60-day period for congressional hearings. It is desirable that these hearings be held in the autumn of 1985, before the midterm elections begin to make congressmen even more sensitive to protectionist pressures than they now are. It is also important that substantial progress be made in negotiating a CAFTA before both countries become preoccupied with the next round of multilateral trade negotiations. Indeed, serious negotiations for a CAFTA could be a catalyst to the multilateral negotiations. Canada and the United States could pioneer approaches to the liberalization of trade in services and to the treatment of investment issues that would be useful

in multilateral negotiations.

The time has come for Canada to take the initiative in launching negotiations for a CAFTA. By liberalizing trade now, with all of its positive consequences for the Canadian economy, Canada would take a decisive step into the future. By doing so now, Canada might also be able to preempt protectionist actions in the United States.

An Act of Canadian Confidence

This Canadian initiative would not be an act of desperation but of confidence. A CAFTA offers the most promising opportunity to create a more efficient, adaptive, and outward-looking Canadian — and U.S. — economy that would provide rising living standards and expanding employment opportunities for the great majority of people. Its success would demonstrate to the rest of the world that trade liberalization, rather than rising protectionism, remains — as it has since World War II — the practical key to prosperity.

Policy Analysis Committee

The C.D. Howe Institute Policy Analysis Committee (HIPAC) was formed in 1980 from the Canadian Economic Policy Committee, established in 1961. This change was brought about to help streamline the Institute's activities and to improve the process of accountability of staff to the Institute's members.

HIPAC's membership is drawn primarily from business and labor organizations that are members of the Institute. To encourage diversity of perspective, HIPAC also includes members from the academic world, from agricultural organizations, and from the professions. Two Regional Advisory Committees have been established across the country to assist HIPAC in determining its research agenda and to ensure that the research conducted by the Institute on its behalf is relevant and reflective of regional points of view.

Full meetings of HIPAC's membership are held twice each year. The purposes of these meetings are to hear expert speakers on current policies, to engage in frank discussion of topics raised by members, and to identify a research program that the Institute can effectively carry out to improve public understanding of important policy issues. The professional completion of this program is then supervised by the Institute, which coordinates with the HIPAC Executive Committee.

The Chairman of HIPAC is H.A. Hampson (President and Chief Executive Officer, Canada Development Corporation).

Recent publications prepared in conjunction with HIPAC include:

- *The Federal Budget: All Things to All People?*, C.D. Howe Institute Commentary, by Edward A. Carmichael and Wendy Dobson (April 1985).
- *Policy Review and Outlook, 1985: Time for Decisions*, by Edward A. Carmichael (February 1985).
- *Education Policy in Canada: The Urgent Issues*, C.D. Howe Institute Commentary, by Claude E. Forget (January 1985).
- *Time for a Strategic Economic Agenda*, C.D. Howe Institute Commentary, by Wendy Dobson and Peter Bartha (September 1984).
- *National Consultation: Problems and Prospects*, Policy Commentary no. 5, by John Crispo (September 1984).
- *Tackling the Federal Deficit*, Observation no. 26, by Edward A. Carmichael (August 1984).